S. HRG. 98-426

GNP AND ECONOMIC OUTLOOK

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

FIRST SESSION

JULY 19 AND 21, 1983

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
26-903 O WASHINGTON: 1983

J841-2

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Congress)

SENATE	HOUSE OF REPRESENTATIVES
ROGER W. JEPSEN, Iowa, *Chairman*	LEE H. HAMILTON, Indiana,
WILLIAM V. ROTH, Jr., Delaware	*Vice Chairman*
JAMES ABDNOR, South Dakota	GILLIS W. LONG, Louisiana
STEVEN D. SYMMS, Idaho	PARREN J. MITCHELL, Maryland
MACK MATTINGLY, Georgia	AUGUSTUS F. HAWKINS, California
ALFONSE M. D'AMATO, New York	DAVID R. OBEY, Wisconsin
LLOYD BENTSEN, Texas	JAMES H. SCHEUER, New York
WILLIAM PROXMIRE, Wisconsin	CHALMERS P. WYLIE, Ohio
EDWARD M. KENNEDY, Massachusetts	MARJORIE S. HOLT, Maryland
PAUL S. SARBANES, Maryland	DAN LUNGREN, California
	OLYMPIA J. SNOWE, Maine

BRUCE R. BARTLETT, *Executive Director*
JAMES K. GALBRAITH, *Deputy Director*

CONTENTS

WITNESSES AND STATEMENTS

TUESDAY, JULY 19, 1983

	Page
Jepsen, Hon. Roger W., chairman of the Joint Economic Committee: Opening statement	1
Hamilton, Hon. Lee H., vice chairman of the Joint Economic Committee: Opening statement	2
Regan, Hon. Donald T., Secretary of the Treasury	2

THURSDAY, JULY 21, 1983

Jepsen, Hon. Roger W., chairman of the Joint Economic Committee: Opening statement	43
Hamilton, Hon. Lee H., vice chairman of the Joint Economic Committee: Opening statement	44
Chimerine, Lawrence, chairman and chief economist, Chase Econometrics, Bala Cynwyd, Pa	44
Rahn, Richard W., vice president and chief economist, Chamber of Commerce of the United States, accompanied by Ronald Utt, deputy chief economist, and Grace Ortiz, director, forecast center	72

SUBMISSIONS FOR THE RECORD

TUESDAY, JULY 19, 1983

Regan, Hon. Donald T.: Prepared statement	9

THURSDAY, JULY 21, 1983

Chimerine, Lawrence: Prepared statement	49
Rahn, Richard W., et al.: Prepared statement	75

GNP AND ECONOMIC OUTLOOK

TUESDAY, JULY 19, 1983

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen and Representatives Hamilton, Scheuer, and Holt.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and George R. Tyler and Paul B. Manchester, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Secretary Regan, we welcome you to this important hearing.

We meet in the atmosphere of general optimism about the U.S. economy. The real gross national product is rising briskly. Millions of new jobs are being created. Inflation is well under control. Productivity is rising. Housing starts are at a 3½-year high. Factories are humming again. Automobile showrooms once again have more customers than salesmen. Retail sales are up strongly and the inventory-to-sales ratio is at an all-time low, providing the incentive for more hiring, more ordering, and more production as businesses seek to rebuild their stocks.

A few months ago, Mr. Secretary, most of the economists were predicting a very anemic recovery, one so fragile that the slightest disturbance would send us back to recession. However, current signs indicate that this is a very strong and broadly based economic recovery.

To give just one example, last month over two-thirds of U.S. firms showed employment increased compared to only one out of three companies showing such increases in the fourth quarter of 1982.

There are still some pessimists out there, but the predominant weight of evidence today is on the side of optimists, and I believe you would agree to that.

Mr. Secretary, we sometimes get conflicting signals from different administration officials as to where we are and where the U.S. economy is heading, the most talked about issue being Federal deficits, their potential economic impact, and what to do about them.

Recovery is much stronger than was anticipated when the initial budget decisions were made earlier this year. We would like to know if this changes the administration's budget deficit forecast. The Presi-

dent has called for standby tax increases for 1985 and 1986. Will these still be necessary? Or will faster recovery reduce outyear deficits enough so that we can do without future tax increases.

We hope you can enlighten us on these issues and others and give us the authoritative word of the administration on the state and trend of the economy.

We appreciate your taking time from a very busy schedule to be with us here today.

Nothing is more important than the good health of the U.S. economy. It has personal, social, political, national security, and U.S. world competitiveness implications which do affect us all.

I will now yield to the very distinguished vice chairman of this committee for any remarks he would care to make.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative HAMILTON. Thank you very much, Mr. Chairman.

We are all very pleased that a good recovery is underway. At the risk of being a little bit on the pessimistic side, let me recall for you the events of my Fourth of July weekend, Mr. Secretary.

I was in eight parades and went to about that same number of picnics. At every single one of them the cry went up, Hamilton, get us jobs, get us jobs.

I know the statistics are improving, and I am very pleased about that. But the real question before us is whether or not this recovery is sustainable not just for the balance of this year, but through 1984 and beyond.

I think the chairman is correct when he pointed to some of the problems that loom that may make that recovery not sustainable. We all hope that it will be sustainable, as much on this side of the aisle as on the other side in this Congress.

I hope that in the course of today's hearing you will comment about the sustainability of this recovery and what you see looming for us, not just in the next few months, but beyond that as well.

We are very pleased indeed to have you here. We welcome you. We always look forward to your testimony.

Thank you very much, Mr. Chairman.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Mr. Chairman, I have no opening statement, but I certainly welcome the Secretary here this morning. I am pleased to have him.

Senator JEPSEN. Secretary Regan, again welcome. To the best of my knowledge I think this is the first hearing that I have had where, without exception, everyone seems to agree that economic recovery is on the way. The question now is: Is it sustainable and how long will it last?

I am looking forward to your remarks. Please proceed.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman and members of the committee.

I am grateful for the opportunity to meet with you to discuss the state of the economy at midyear. At the beginning of this year the economic recovery was only a forecast. Now, some 6 months later, there is clear evidence that a strong and sustainable recovery is underway.

This administration is committed to strong growth, and we support stable policies in order to make continuing gains. Under this administration the worst period of peacetime inflation in our history has been brought to a close. The task that lies ahead is to promote more economic growth without returning to the inflationary practices of the past.

The economy is now in a healthy recovery phase. The Department of Commerce's early unofficial estimate of the second quarter real growth shows a 6.6-percent annual rate of increase compared with the first quarter's rise at a 2.6-percent annual rate and a decline in the fourth quarter of last year.

The improvement in the economy is beginning to be reflected in the unemployment rate. The civilian unemployment rate has been reduced from 10.8 percent in December of 1982 to 10 percent in June. Unemployment has declined by almost 900,000 persons since its December 1982 peak.

An additional feature of the labor market situation has not received the attention it deserves. Success in bringing down inflation has led to sizable gains in real wages, even though the rates of growth in money wages and labor costs have been slowing down. Money wage growth has slowed as part of the disinflationary process and in part as a result of the tax reduction program and the slowing of inflation-induced bracket creep.

This favorable pattern is shown in the first chart.[1] You can see how nominal compensation per hour, which was increasing sharply through 1980, has now begun to decrease. At the same time real compensation per hour, which was negative in 1979 through 1981, has risen in 1982 and in the first quarter of 1983.

As a matter of fact, real hourly compensation—wages plus fringes—in the nonfarm business sector rose at a 6.4-percent annual rate in the first quarter of this year and by 2.3 percent over the previous four quarters. That stands in marked contrast to the situation of the past decade. Between 1972 and 1982 real compensation per hour in the nonfarm business sector did not rise at all on a pretax basis and actually fell after taxes despite a rise of about 130 percent in the level of money compensation per hour. Surely this demonstrates the futility of trying to raise real wages through inflation. Wage earners lost steadily throughout the decade as inflation and the tax system combined to shrink the purchasing power of their take-home pay.

Labor will benefit along with everyone else from an economic recovery which provides expanding employment opportunities and stable purchasing power. Broad measures of consumer confidence have strengthened significantly this year and consumer buying plans are up sharply. And finally, there are the financial markets themselves.

In my 35 years of investment experience, I have never witnessed anything approaching the current explosion of confidence in the

---

[1] Charts I through IX may be found in Secretary Regan's prepared statement beginning on p. 19.

equity market. Over the first 7 months of this recovery, corporations sold more than $30 billion of equity, both common and preferred issues. That far exceeds the full year totals of 1980 and 1981 and virtually matches the $30.5 billion issued in all of 1982. By way of contrast, during the first 7 months of the recovery from 1973 to 1975, corporate equity issues totaled only a little more than $7 billion. Equity issues so far in this recovery are roughly four times the dollar amount of those during the first 7 months of the 1975 recovery.

This burst of confidence in the economic future testifies to the fundamental improvement that has recently taken place in the business and financial environment. The policies put in place over the last 2 years have made a fundamental difference.

The rapidly improving economic situation has been reflected recently in a wide range of statistics and the current recovery is shaping up very favorably in comparison with previous experience.

Earlier in the year, as you remarked, Mr. Chairman, it was assumed that the recovery would inevitably be subnormal. But that no longer appears to be the case. Let me cite just a few examples, taking November 1982 as the low point of the recession, and referring to chart II.

Industrial production was up at about a 14½-percent annual rate through June, a bit more than in the other post-Korean war recoveries. The index of leading indicators was up at about a 22-percent annual rate, compared to 19 percent in earlier recoveries.

Manufacturing employment was up at more than a 3-percent annual rate through June, ahead of the pace of the earlier recoveries. Real retail sales were up at about a 9½-percent annual rate through June, also more than in past recoveries.

So a much stronger economic recovery has been achieved than most have expected, and I am confident of our ability to deal with the problems that remain.

Recent improvements in the economy are leading us to mark up our forecast for this year one more time. The economic path to underlie our midsession budget review—which will be later this month—will contain a rise in real GNP of 5½ percent from the fourth quarter to the fourth quarter. That appears to be well within the range of private forecasts, as shown in chart III [indicating].

You can see the forecasts of the administration, the average of 3 private econometric models—DRI, Chase, and Wharton—and the blue chip consensus of some 46 economists. To the left are the January forecasts, in the center are those made in April, and on the right are the July forecasts. At this point, the administration is slightly more bullish than the models or the blue chips, but I suspect as they revise their forecast, theirs, too, will come up alongside of ours.

We expect the momentum now building to spill over into 1984, and we are nudging up the projected growth rate for that year to 4½ percent from the 4 percent carried in our January and April forecasts.

We have not measurably altered our forecast of inflation. We still expect gradual unwinding of the remaining inflation following the dramatic improvement of the past 2 years. The rebound in productivity is proceeding faster than we projected earlier, and we have marked up our forecast of productivity growth. With the higher real GNP, we now project workers will be drawn from the unemployment

rolls slightly faster than in our earlier forecast. The unemployment rate is projected to be 9¾ percent in the final quarter of this year and about 8¾ percent in the final quarter of next year on the civilian labor force basis. Continued strong expansion of the economy will continue to bring unemployment down.

The full budgetary effects of the revised official forecast will be spelled out in the midsession budget review to be released later this month. The new economic forecast carries with it more favorable budgetary implications.

On the revenue side, the stronger growth now underway is expected to raise Treasury tax receipts by an additional $95 billion between now nad 1988, or $55 billion by 1986. The extra tax revenue amounts to almost 75 percent of the proposed tax bill contained in the current budget resolution of the Congress. Hopefully, this added revenue will not be spent and will result in a corresponding reduction in the deficit.

Chart IV, Mr. Chairman, illustrates the budgetary situation. Budgetary receipts are projected to range between 18.6 percent and 20.8 percent of GNP between 1983 and 1988. This compares with 18.7 percent from 1964 through 1974 and 19 percent from 1975 through 1979. You can see how receipts as a percent of GNP are anticipated to rise up into the area above 20 percent, which is higher than averaged in most of the past 20 years.

It may seem surprising that tax receipts as a share of gross national product are above their historical levels in spite of the tax reductions enacted in 1981. Since then, we have enacted TEFRA in 1982, and the gasoline tax. Payroll tax charges are occurring, some due to the 1977 social security amendments; some due to the 1983 amendments. And bracket creep continues in spite of reduced inflation.

That is why we urge that the budget be brought toward balance by economic growth and spending restraint, not by tax increases. Those who urge a supposedly balanced approach of tax increases and spending cuts are advocating semantic balance only, not real economic balance. The current situation has been unbalanced by years of "tax and tax, spend and spend."

A quick look at the tax status of a middle-income family illustrates this clearly. Chart V shows the family's tax burden both as a percent of income and in real 1982 dollars under the personal income tax and the employee's half of the payroll tax.

Before passage of the Economic Recovery Tax Act of 1981, the family's real tax burden was rising sharply due to inflation-induced bracket creep and payroll tax rate increases scheduled under the 1977 social security amendments for 1981, 1982, 1985, 1986, and 1990. Under prior law, the family earning $25,000 in 1982 would have seen its tax burden rising from below 16 percent of income in 1978 and 1979 to above 21 percent of income in 1988 and higher in 1990.

You can see that, Mr. Chairman, in this black line [indicating], which shows the increases that were in law in 1980, had they not been changed. As you can see, the first tax cuts have held this family's tax burden at a more constant level. Were the 1983 tax cut and indexing repealed, taxes would increase sharply. The 1983 tax increase was not repealed. Therefore, the bottom line keeps coming down. If indexing is repealed, taxes shoot up to above 18 percent of income by 1988.

Under current law, assuming that indexing stays in, the tax burden remains at about 17 percent of their total income, coming up from about 15¾ percent in 1978.

We have stopped the growth of the tax burden as a percent of income; we have not slashed tax rates nor destroyed the tax base; we have not frozen receipts in dollar terms. And this is true across most of the middle-income level, as charts VI and VII will illustrate.

Spending is clearly the source of the long-term budget problems. It was 23 percent and 23.6 percent of GNP in 1980 and 1981, respectively, and was 24.6 percent of GNP by 1982. This compares to 19.8 percent from 1964 through 1974 and 22.1 percent from 1975 through 1979. The administration recommends a decline to under 23 percent of GNP by 1988.

Private-sector investment and consumption can expand as a share of GNP only when the Government spending ratio falls. If we want more private-sector activity, including growth-related activity such as production of more plant, and equipment, and construction of more commercial and residential structures, then we must free up physical, not just financial, resources of the private sector by cutting the Government's use of physical, not just financial, resources over time.

The financial or dollar amounts are merely the other side of the coin, as it were, of the acquisition of physical goods. Once it spends money to buy goods and services, the Government will have to meet its financial needs through taxing or borrowing. Whichever means of financing is chosen—taxing or borrowing—the Government gets the physical resources. The Government is currently taking far too large a slice of that pie; it is undercutting the economy's longrun growth potential in the process and will continue to do so unless the ratio of spending to gross national product is lowered.

Turning to budget deficits and the financial markets. Many people attribute the recent rise in interest rates to the burden of a Federal budget deficit on the credit markets. This is not the case. The Treasury's borrowings have been relatively heavy, as projected for the first half of this year, but in the meantime, net private demands on the credit markets have been moderate. The financing demands of U.S. businesses have been easily met in capital markets despite the deficit financing demands of the Federal Government.

Table I of my prepared statement shows that internal cash flows from corporate operations more than covered cash outflows for capital spending in the first quarter. One reason for this was the sharp cutback in funds needed to finance business inventory holdings, which were run down at a very rapid pace over the past 6 months.

Another important factor easing private demands has been the increased business cash flow due to increased depreciation allowances and liberalized investment tax credits. The financial position of partnerships and proprietorships has also been improved by the personal tax reductions, as well as by ACRS and tax credits. Net corporate borrowing should continue to be relatively modest during the balance of this year.

Because credit demands have moderated at the time of peak Federal deficits, the Treasury has been able to finance without as much pressure on the financial markets as many had feared. This should not have

come as a surprise. It is, in fact, the typical cyclical pattern. Chart VIII, my next chart, Mr. Chairman, shows a clear inverse relationship between Government and private-sector borrowing.

You will notice here in times of recession how the private-sector borrowing drops as Government demands for credit are rising. Those patterns repeat time after time in all of the recessions and recovery periods.

Nor is the recent interest rate increase, particularly the short-term rates, due to a worsening of market expectations regarding the outyear deficits. The upward revisions in deficit forecasts over the last 2 years have been accompanied by falling interest rates.

And this last chart IX tries to demonstrate that. We have the various forecasts by DRI of what the 1985 budget deficit should be. You can see back in late 1980 they were forecasting a deficit of between $50 billion and $100 billion. As time went on, their deficit forecast got up to over $100 billion. In 1982 and in 1983 they are forecasting well over a $200 billion deficit for 1985. Rates on 5-year Treasury notes in 1980, which would have come due in 1985, were rising. The rates in both nominal and real terms started falling as projections went up.

This does not mean that budget deficits never cause financial difficulties. Deficits are a potential problem and an important reason for controlling Federal spending. But the recent rise in interest rates is not due to the large Federal deficits: the recent flip in rates is the result of a sharp upsurge in the money supply that has taken place over the last several months.

There obviously has been a slight firming of monetary policy in recent weeks in response to the strength of the money supply. The Federal funds rate has been pushed up gradually from about 8½ percent in late April to a range of about 9 to 9½ percent recently. In addition, the monetary base has shown little net change since the beginning of June.

It is important to recognize that these are small firming steps by the Fed designed to reduce the growth of the money supply gradually. In the past the Fed has sometimes acted too strongly on such occasions and the result has been a credit crunch that damages the economy. This must not be the case this time, and we do not believe that it will be.

In conclusion, many of those who raise a great hue and cry about deficits never explain the real cause of the red ink that threatens all we have accomplished to date. They seem to think that deficits are caused because people don't pay enough taxes. That is ridiculous.

The real reason we confront massive deficits is Congress massive indifference to the need to impose self-discipline on spending habits. The President is determined to stand his ground on this one. He will not yield to those who call for a little more taxation now and a little more taxes next year. A little tax increase as we are coming out of the recession is bad economics; it would stunt the recovery and probably enlarge the deficit.

Now let me be clear on this point. I am not dismissing the implications of indefinitely high deficits. In the short term we are fully confident of being able to finance them without crowding out private investment. But down the road, when the savings and investment process gets into full gear, it could be a different story. That is why every effort must be made now to get Federal spending under control.

So let me make a final, modest proposal. Just as the current budget situation took years to develop, so future deficits will not be controlled if we wait until 1986 or 1987. The April projection of Federal spending for fiscal year 1988 calls for $1 trillion, 125 billion. Why can we not work backwards from that astronomical sum? By retaining tax rates at about the level to which the President's program was designed to reduce them we can generate a trillion dollars for that year's Federal budget.

Surely a trillion dollars is enough to take care of our defense needs, provide for the security of all of our citizens in genuine need, and shoulder the burden of interest accumulated over half a century of deficit spending. We need to begin now to set such a goal, without slamming on the brakes 5 years down the road.

Individuals and businesses plan for the long term. The financial markets do likewise. The Federal establishment must do likewise. By working together Congress and the administration can insure that this recovery fulfills its promise and takes its place among the longest and strongest in U.S. history.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Regan follows:]

PREPARED STATEMENT OF HON. DONALD T. REGAN

Mr. Chairman and Members of the Committee:

I am grateful for the opportunity to meet with you to discuss the state of the economy at midyear. At the beginning of this year, the economic recovery was only a forecast. Now, some six months later, there is clear evidence that a strong and sustainable recovery is underway. This Administration does not object to strong growth, it only requests the support of stable policies in order to make continuing gains. Under this Administration, the worst period of peacetime inflation in our history has been brought to a close. The task that lies ahead is to promote more economic growth without returning to the inflationary practices of the past.

The Recent Improvement in the Economy

The economy is now in a healthy recovery phase. The Department of Commerce's early unofficial estimate of second quarter real growth shows a 6.6 percent annual rate of increase, compared with the first quarter's rise at a 2.6 percent annual rate, and a decline in the fourth quarter of last year.

The improvement in the economy is beginning to be reflected in the unemployment rate. Some ten days ago the Department of Labor announced that the civilian unemployment rate edged down to 10.0 percent in June (9.8 percent on the new basis including the resident Armed Forces in the labor force base). The June household survey showed a large 1.2 million rise during the month in both the labor force and employment. Other measures of progress over a longer span of time may be more informative:

- The civilian unemployment rate has been reduced from 10.8 percent in December 1982 to 10.0 percent in June.
- Unemployment has declined by almost 900,000 persons since its December 1982 peak.
- Employment on non-agricultural payrolls has risen by 1.1 million persons over the same period of time.
- Average hours worked have increased and the number of those forced to work part time for economic reasons has fallen.

An additional feature of the labor market situation has not received the attention that it deserves. Success in bringing down inflation has led to sizable gains in real wages, even though the rates of growth in money wages and labor costs have been slowing down. Money wage growth has slowed as part of the disinflationary process and in part as a result of the tax reduction program and the slowing of inflation-induced bracket creep. This favorable pattern is shown in Chart I. It would appear even more striking on an after-tax basis.

Real hourly compensation (wages plus fringes) in the nonfarm business sector rose at a 6.4 percent annual rate in the first quarter of this year (the latest figures available) and by 2.3 percent over the previous four quarters. This stands in marked contrast to the situation over the past decade. Between 1972 and 1982, real compensation per hour in the nonfarm business sector did not rise at all on a pre-tax basis and actually fell after taxes despite a rise of about 130% in the level of money compensation per hour. Surely this demonstrates the futility of trying to raise real wages through inflation. Wage earners lost steadily throughout the decade as inflation and the tax system combined to shrink the purchasing power of their take-home pay. Labor will benefit along with everyone else from an economic recovery which provides expanding employment opportunities and stable purchasing power.

Incentives to work, save and invest are beginning to be restored throughout the economy and confidence in future economic performance is rising. The Conference Board recently reported that in the second quarter its measure of business confidence -- based on survey responses from about 1500 corporate chief executives -- reached its highest point in the seven-year history of the survey. Broad measures of consumer confidence have strengthened significantly this year and consumer buying plans are up sharply. Finally, there are the financial markets themselves.

In my thirty-five years of investment experience, I have never witnessed anything approaching the current explosion of confidence in equity markets. Over the first seven months of this recovery, corporations sold more than $30 billion of equity, both common and preferred issues. That far exceeds the full-year totals in 1980 and 1981 and virtually matches the $30-1/2 billion issued in all of 1982. By way of contrast, during the first seven months of the recovery from the 1973-75 recession, corporate equity issues totalled only a little more than $7 billion. Equity issues so far in this recovery are roughly four times the dollar amount of those during the first seven months of the 1975 recovery. This burst of confidence in the economic future testifies to the fundamental improvement that has recently taken place in the business and financial environment. The policies put in place over the last two years have made a fundamental difference.

The rapidly improving economic situation has been reflected recently in a wide range of statistics and the current recovery is shaping up very favorably in comparison with previous experience. Earlier in the year it was assumed that the recovery would inevitably be subnormal, but that no longer appears to be the case. Let me cite just a few examples, taking November 1982 as the low point of the recent recession, and referring to Chart II.

-- Industrial production was up at about a 14-1/2 percent annual rate through June.

-- The index of leading indicators was up at about a 22 percent annual rate, compared to about 19 percent in earlier recoveries.

-- Manufacturing employment was up at more than a 3 percent annual rate through June, somewhat ahead of the pace in earlier recoveries.

-- Real retail sales were up at about a 9-1/2 percent annual rate through June.

All of this recent good news on the economic situation is welcome. We are on the right track, but it is clear that there are some potential threats to continuing strong performance. Interest rates are still high and the Federal budget is not yet securely under control. These and other problems must be dealt with effectively. But a much stronger economic recovery has been achieved than most had expected, and I am confident of our ability to deal with the problems that remain.

Revisions to the Official Economic Forecast

The mounting evidence of good economic news has forced us to rethink our forecast once again. If you recall, when we put together our economic forecast for the January budget we were rather cautious, as definite signs of a turnaround from the recession were only beginning to emerge.

By the early spring, it was increasingly clear that the economy had moved into recovery, and in the April Update of the Budget we raised our forecast of real growth during 1983 to 4.7 percent from 3.1 percent. We again were overly cautious. After the April forecast, statistics on the economy indicated a continually better performance.

-- Industrial production soared at an annual rate of 18 percent during the latest three months available and new orders for durable goods increased at a 42 percent rate.

-- Employment in the non-farm economy scored three successive large monthly gains during the second quarter, averaging 315,000 per month. This compares with average monthly gains of only 50,000 during the first quarter.

-- Consumer spending turned around. Retail sales spurted at a 27 percent annual rate over the past three months, with most of that rise reflecting increased volume as opposed to higher prices.

-- Plant and equipment spending held up somewhat better during the past recession than would have been expected on the basis of past cyclical experience, and apparently posted small gains in real terms during the first and second quarters of this year. The turnaround in capital spending may come sooner than many expected.

These and related developments are leading us to mark up our forecast for this year one more time. The economic path to underlie our Mid-Session Budget Review (to be released later this month) will contain a rise in real GNP this year of 5-1/2 percent (fourth quarter to fourth quarter). That appears to be well within the range of private forecasts as shown in Chart III. We expect the momentum now building to spill over into 1984, and we are nudging up the projected growth rate for that year to 4-1/2 percent from the 4 percent carried in our January and April forecasts.

We have not measurably altered our forecast of inflation. We still expect gradual unwinding of the remaining inflation, following the dramatic improvements of the past two years. The rebound in productivity (the real output per hour worked) is proceeding faster than we projected earlier, and we have marked up our forecast of productivity growth. With the higher real GNP, we now project workers will be drawn from the unemployment rolls slightly faster than in our earlier forecast. The unemployment rate is projected to be 9-3/4 percent in the final quarter of this year and about 8-3/4 percent in the final quarter of next year (civilian labor force basis). Continued strong expansion of the economy will continue to bring unemployment down.

Budgetary Implications of the Mid-Session Review

The full budgetary effects of the revised official forecast will be spelled out in the Mid-Session Budget Review to be released later this month. The new economic forecast carries with it more favorable budgetary implications. On the revenue side, the stronger growth now underway is expected to raise Treasury tax receipts by an additional $95 billion between now and 1988, or $55 billion by 1986. The extra tax revenue amounts to almost 75 percent of the proposed tax bill contained in the current budget resolution. Hopefully this added revenue will not be spent and will result in a corresponding reduction in the deficit.

Chart IV illustrates the budgetary situation. Budget receipts are projected to range between 18.6 and 20.8 percent of GNP between 1983 and 1988. This compares with 18.7 percent from 1964 through 1974 and 19.0 percent from 1975 through 1979. Receipts were 20.1 and 20.9 percent of GNP in 1980 and 1981, respectively, and were 20.4 percent in 1982. Receipts, therefore, will be in line with or even higher than historical levels.

26-903 O - 83 - 2

It may seem surprising that tax receipts as a share of GNP are above their historical levels in spite of the tax reductions enacted in 1981. Since then, we have enacted TEFRA and the gasoline tax. Payroll tax changes are occurring, some due to the 1977 Social Security Amendments, some due to the 1983 Amendments. And bracket creep continues in spite of reduced inflation.

This is why we urge that the budget be brought toward balance by economic growth and spending restraint, not by tax increases. Those who urge a supposedly "balanced" approach of tax increases and spending cuts are advocating semantic balance only, not real economic balance. The current situation has been unbalanced by years of "tax, tax, spend, spend."

A quick look at the tax status of a middle income family illustrates this clearly. Chart V shows the family's tax burden both as a percent of income and in real 1982 dollars under the personal income tax and the employee's half of the payroll tax.

Before passage of the Economic Recovery Tax Act of 1981, the family's real tax burden was rising sharply due to inflation-induced bracket creep and payroll tax rate increases scheduled under the 1977 Social Security Amendments for 1981, 1982, 1985, 1986, and 1990. Under prior law, the family earning $25,000 in 1982 would have seen its tax burden rise from below 16 percent of income in 1978 and 1979 to above 21 percent of income in 1988 and higher in 1990.

Our tax program has leveled off the family's tax burden at roughly 16.6 percent of income over the 1982 - 1988 period. This is the same rate as in 1980 prior to ERTA; it is below the 17.7 percent peak rate the family paid in 1981, the highest rate in peacetime history, but above the tax rate the family faced in the 1970s. In fact, the family will pay a slightly higher percent of income in tax at the end of the decade than at the beginning, as the 1988 and 1990 Social Security tax increases come due.

We have stopped the growth of the tax burden as a percent of income. We have not slashed tax rates nor destroyed the tax base. We have not frozen receipts in dollar terms. And this is true across most of the middle income levels, as Charts VI and VII illustrate.

Spending is clearly the source of the long-term budget problems. It was 23.0 and 23.6 percent of GNP in 1980 and 1981, respectively, and was 24.6 percent of GNP in 1982. This compares to 19.8 percent from 1964 through 1974 and 22.1 percent from 1975 through 1979. The Administration recommends a decline to under 23 percent of GNP by 1988.

In principle, the outyear deficits could be cured in two ways, or by some combination of the two alternatives. Taxes could be raised as a percentage of GNP into equality with the higher spending totals. Alternatively, spending could be lowered as a percentage of GNP into equality with projected tax receipts. Why do we argue so consistently that it is the spending-GNP ratio that needs to be lowered?

Private sector investment and consumption can expand as a share of GNP only when the Government-spending ratio falls. If we want more private sector activity, including growth-related activity such as production of more plant and equipment, and construction of more commercial and residential structures, then we must free up physical (not just financial) resources for the private sector by cutting the Government's use of physical (not just financial) resources over time. That means less Government purchasing of cement, steel, oil, and paper clips, and less hiring of manpower in the outyears if the economy is to continue to expand.

The financial or dollar amounts are merely the other side of the coin, as it were, of the acquisition of the physical goods. Once it spends money to buy goods and services, the Government will have to meet its financial needs through taxing or borrowing. Whichever means of financing is chosen -- taxing or borrowing -- the Government gets the physical resources. Raising taxes to close the deficit in preference to borrowing merely permits the same purchases of physical resources by Government using a different way of raising the same financial resources. Both taxing and borrowing are decidedly inferior to reducing the runaway growth of Government spending.

The Government is currently taking far too large a slice of the pie and will continue to do so unless the ratio of spending to GNP is lowered. No amount of quibbling over financial details -- how much to tax and how much to borrow -- should obscure the fact that Government is drawing too many of our physical resources from the productive private sector and undercutting the economy's long-run growth potential in the process.

Budget Deficits and Financial Markets

Many people attribute the recent rise in interest rates to the burden of the Federal budget deficit on the credit markets. That is not the case. The Treasury's borrowings have been relatively heavy, as projected for the first half of the year. But, in the meantime, net private demands on the credit market have been moderate. The financing demands of U.S. businesses have been easily met in capital markets, despite the deficit financing demands of the Federal Government. A rise in corporate cash flow, the drop in interest rates, a jump in stock prices, and increased inflows to security markets have combined to help corporations fund their operations with more ease than many had expected.

Table I shows that internal cash flows from corporate operations more than covered cash outflows for capital spending in the first quarter. One reason for this was the sharp cutback in funds needed to finance business inventory holdings which were run down at a very rapid pace over the past six months. Another important factor easing private demands has been the increased business cash flow due to increased depreciation allowances and liberalized investment tax credits. The financial position of partnerships and proprietorships has also been improved by the personal tax rate reductions as well as by ACRS and tax credits.

Net corporate borrowing should continue to be relatively modest during the balance of the year. Corporations have increased their borrowing in long-term markets, but have been relying less on short-term borrowing. For example, in the first half of this year, short-term business borrowing dropped by almost $4 billion, compared with an increase of nearly $25 billion in the first half of 1982.

Because private credit demands have moderated at the time of peak Federal deficits, the Treasury has been able to finance without as much pressure on the financial markets as many had feared. This should not have come as a surprise. It is, in fact, the typical cyclical pattern. Chart VIII shows a clear inverse relationship between Government and private sector borrowing.

Nor is the recent interest rate increase, particularly the short rates, due to a worsening of market expectations regarding the outyear deficits. The upward revisions in deficit forecasts over the last two years have been accompanied by falling interest rates, as shown in Chart IX.

This does not mean that budget deficits never cause financial difficulties. The fundamentals of public finance tell us that the growth of privately held Federal debt cannot indefinitely exceed the growth of our national income without causing economic instability. That would eventually push up interest rates and disrupt the financing of private sector activity. Deficits are a potential problem and an important reason for controlling Federal spending. But, the recent rise in interest rates is not due to large Federal deficits.

It is true that the last couple of months have seen a fairly significant increase in interest rates. For example, the 3-month bill rate is about a percentage point higher than in early May, and new Aa-rated corporate issues are now being sold at about 12.50 percent, compared with about 11 percent at the beginning of May. The recent blip in rates, however, is the result of the sharp upsurge in the money supply that has taken place in the last two months.

Since late April, the narrow money supply M1, has risen nearly $20 billion which is equivalent to about a 19 percent annual rate. This is a pace of money growth that cannot continue without jeopardizing our hard-won gains against inflation. In fact, recognition of this threat is the reason that the big jumps in the weekly money supply have been greeted by rises in market interest rates as -- correctly or not -- investors anticipate a tighter monetary policy to slow money growth.

There obviously has been a slight firming of monetary policy in recent weeks in response to the strength of the money supply. The Federal funds rate has been pushed up gradually from about 8.50 percent in late April to a range of about 9 to 9-1/2 percent recently. In addition, the monetary base has shown little net change since the beginning of June.

It is important to recognize that these are small firming steps by the Fed designed to reduce the growth of the money supply gradually. In the past, the Fed has sometimes acted too strongly on such occasions and the result has been a credit crunch that damages the economy. This must not be the case this time and we do not believe that it will be. The Fed has been moving cautiously, and we are hopeful that they will remain in control of the situation. As that happens, the current uptick in interest rates will subside and rates can return to lower levels more appropriate for steady and noninflationary growth.

Conclusion

Many of those who raise a great hue and cry about deficits never explain the real cause of the red ink that threatens all we have accomplished to date. They seem to think that deficits are caused because people don't pay enough taxes. That's ridiculous.

The real reason we confront massive deficits is Congress' massive indifference to the need to impose self-discipline on its spending habits. The President is determined to stand his ground on this one. He will not yield to those who call for "a little more taxation now" and "a little more" next year. A little tax increase as we are coming out of the recession is bad economics; it would stunt the recovery and probably enlarge the deficit.

Now let me be clear on this point: I'm not dismissing the implications of indefinitely high deficits. In the short term, we are fully confident of being able to finance them without crowding out private investment. What's more, the psychological impact of such deficits has largely been discounted by the marketplace -- for now. But down the road when the savings and investment process gets into full gear, it could be a different story. That is why every effort must be made now to get Federal spending under control.

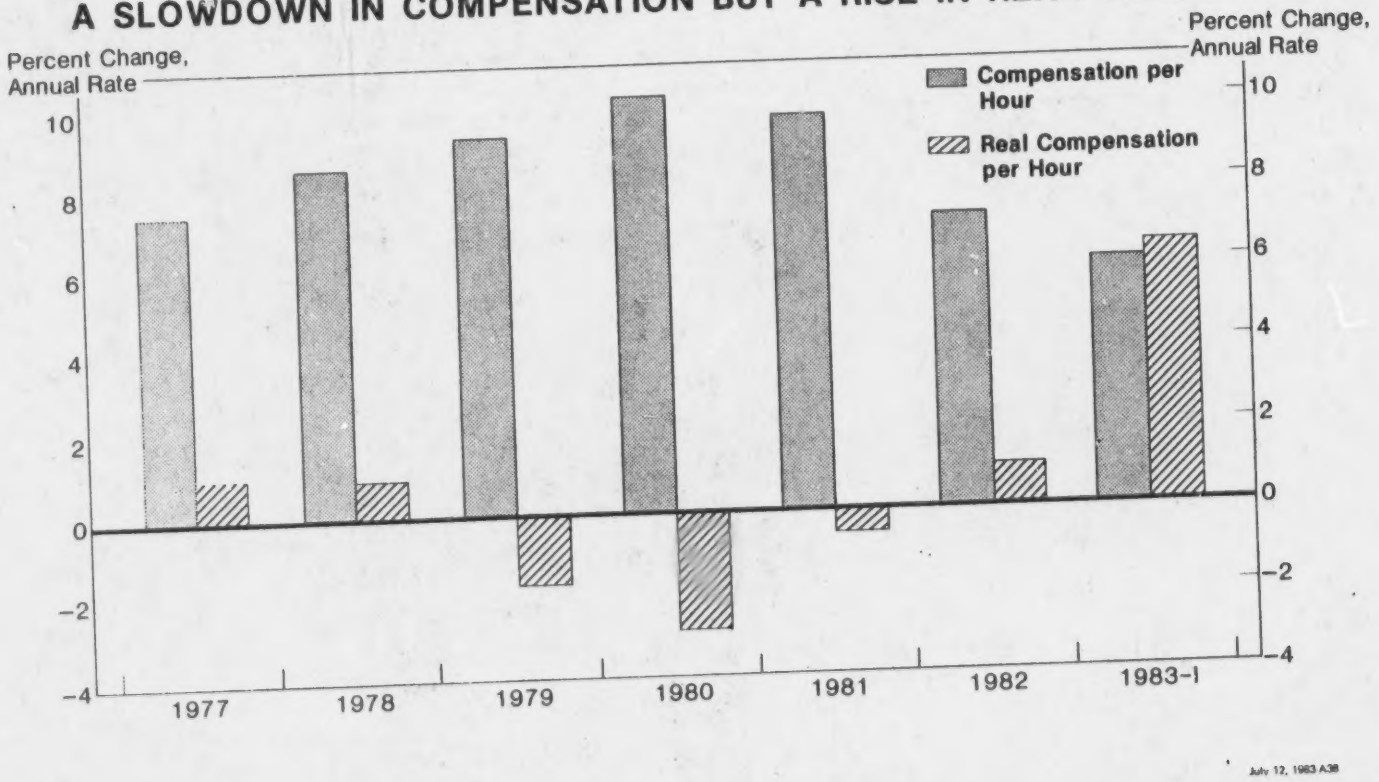
So let me make a final, modest proposal. Just as the current budget situation took years to develop, so future deficits will not be controlled if we wait until 1986 or 1987. The April projection of Federal spending for fiscal year 1988 calls for $1 trillion, 125 billion. Why can't we work backwards from that astronomical sum? By retaining tax rates at about the level to which the President's program was designed to reduce them, we can generate a trillion dollars for that year's Federal budget.

Surely a trillion dollars is enough to take care of our defense needs, to provide for the security of all our citizens in genuine need, and shoulder the burden of interest accumulated over a half century of deficit spending. We need to begin now to set such a goal, without slamming on the brakes five years down the road.

Individuals and businesses plan for the long term. The financial markets do likewise. The Federal establishment must do likewise. By working together, Congress and the Administration can insure that this recovery fulfills its promise and takes its place among the longest and strongest in U.S. history.

Chart I

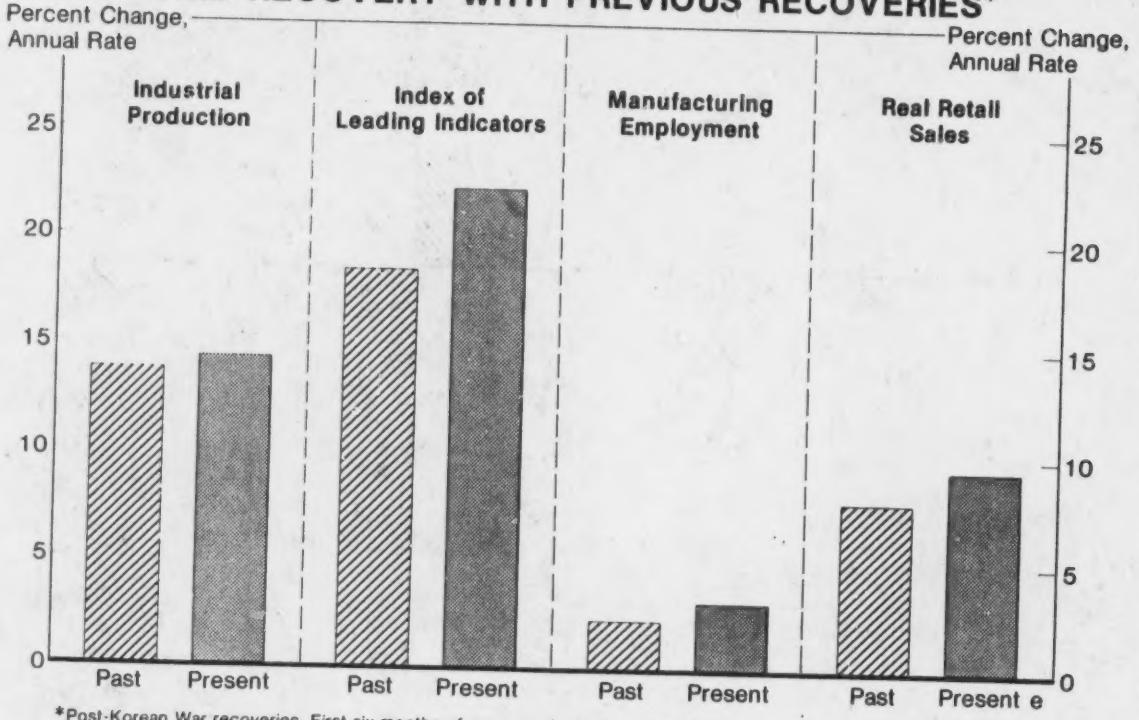
A SLOWDOWN IN COMPENSATION BUT A RISE IN REAL TERMS



July 12, 1983 A38

Chart II

COMPARISON OF THIS RECOVERY WITH PREVIOUS RECOVERIES*



*Post-Korean War recoveries. First six months of recovery for leading indicators, others are first seven months.

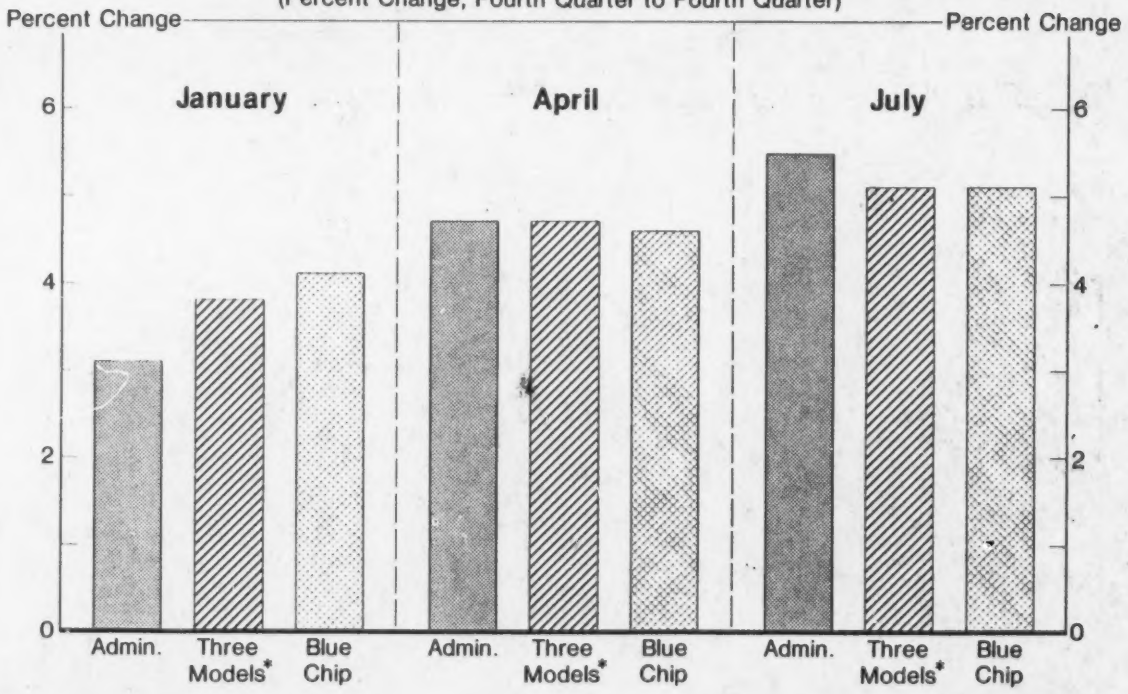
e-estimated

July 17, 1983-A44

Chart III

FORECASTS OF REAL GROWTH FOR 1983

(Percent Change, Fourth Quarter to Fourth Quarter)

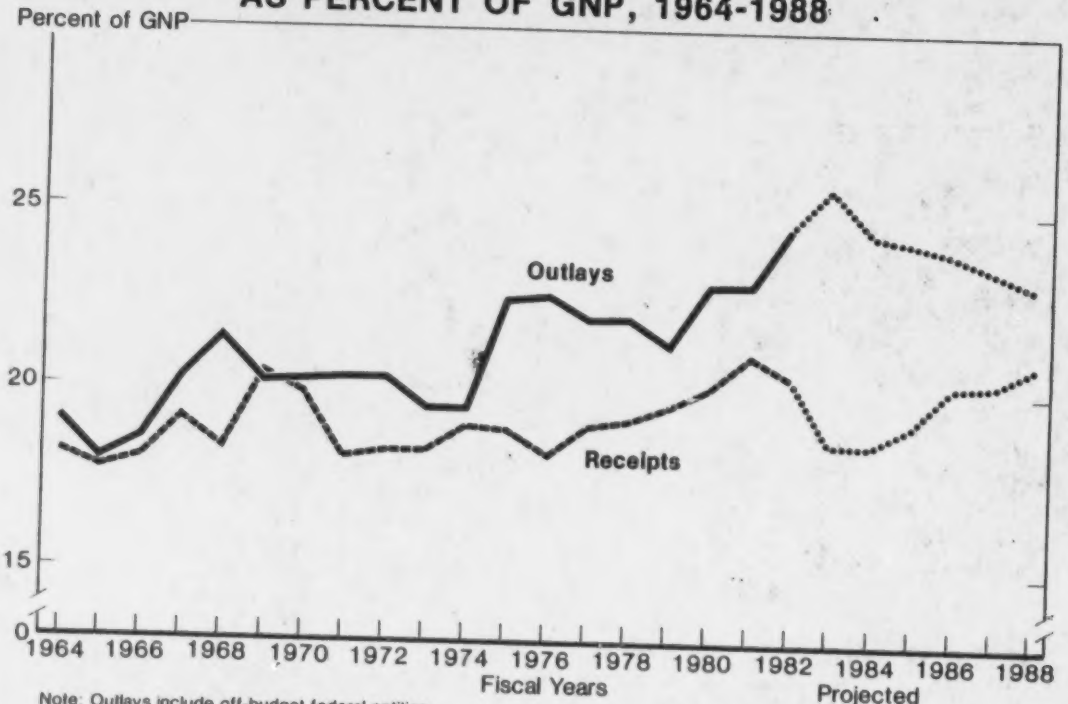


* Average of DRI, Chase and Wharton.

July 12, 1983-A46

Chart IV

BUDGET OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1988



Note: Outlays include off-budget federal entities.
Source: Based on April update of the Budget.

June 9, 1983-A233

Chart V

Real Tax Burden
(Income & Employee Payroll Tax)

Family of Four with an Income of $25,000
in 1982 with Cost of Living Adjustments

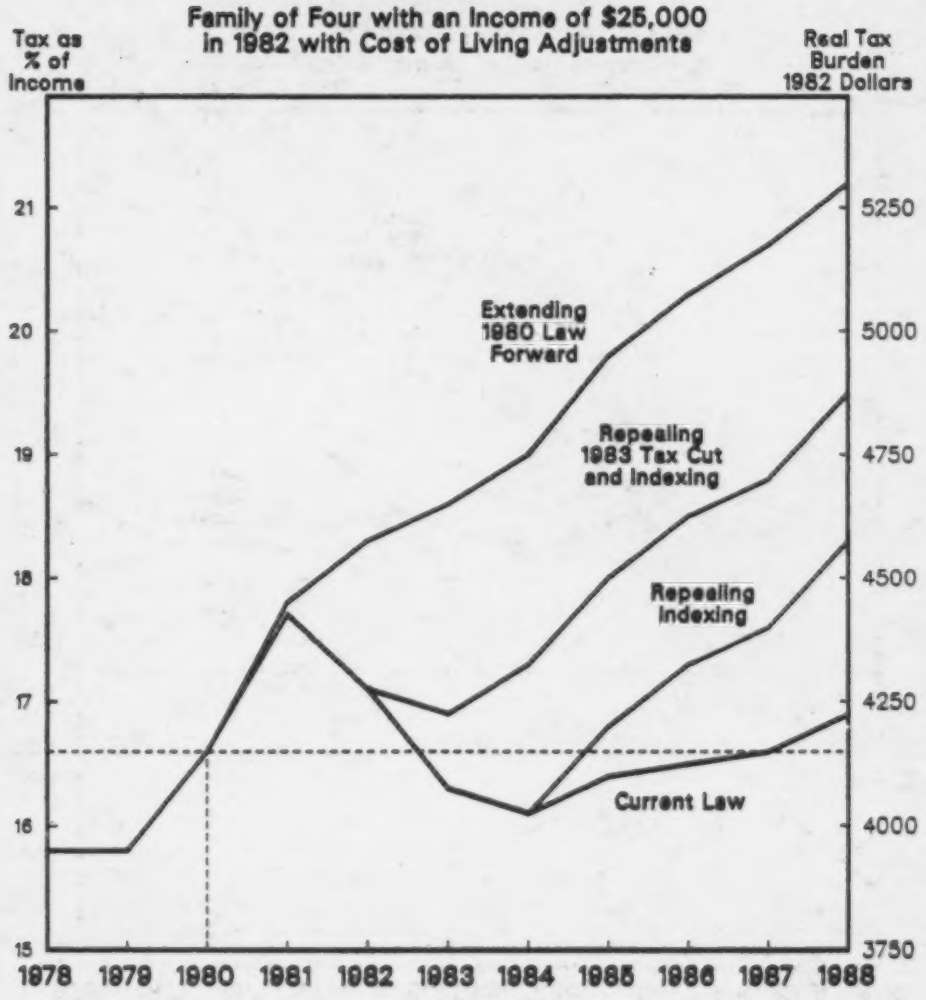


Chart VI

Real Tax Burden
(Income & Employee Payroll Tax)

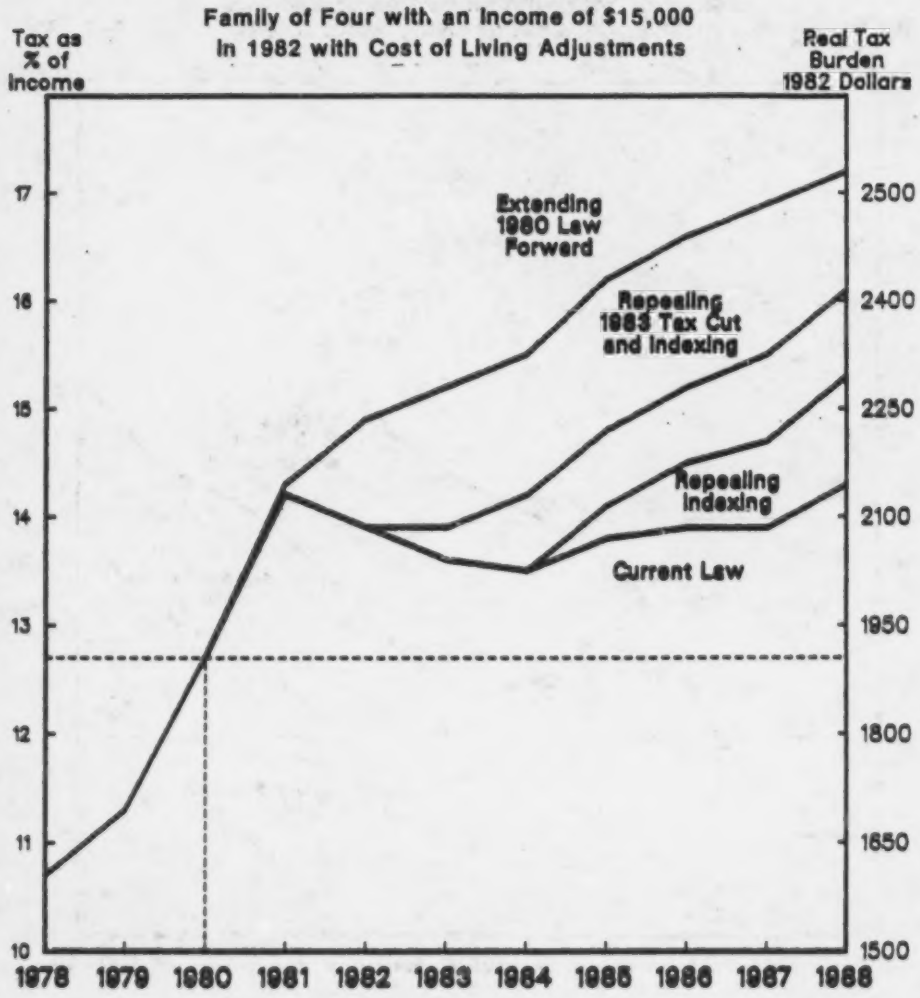


Chart VII

Real Tax Burden
(Income & Employee Payroll Tax)

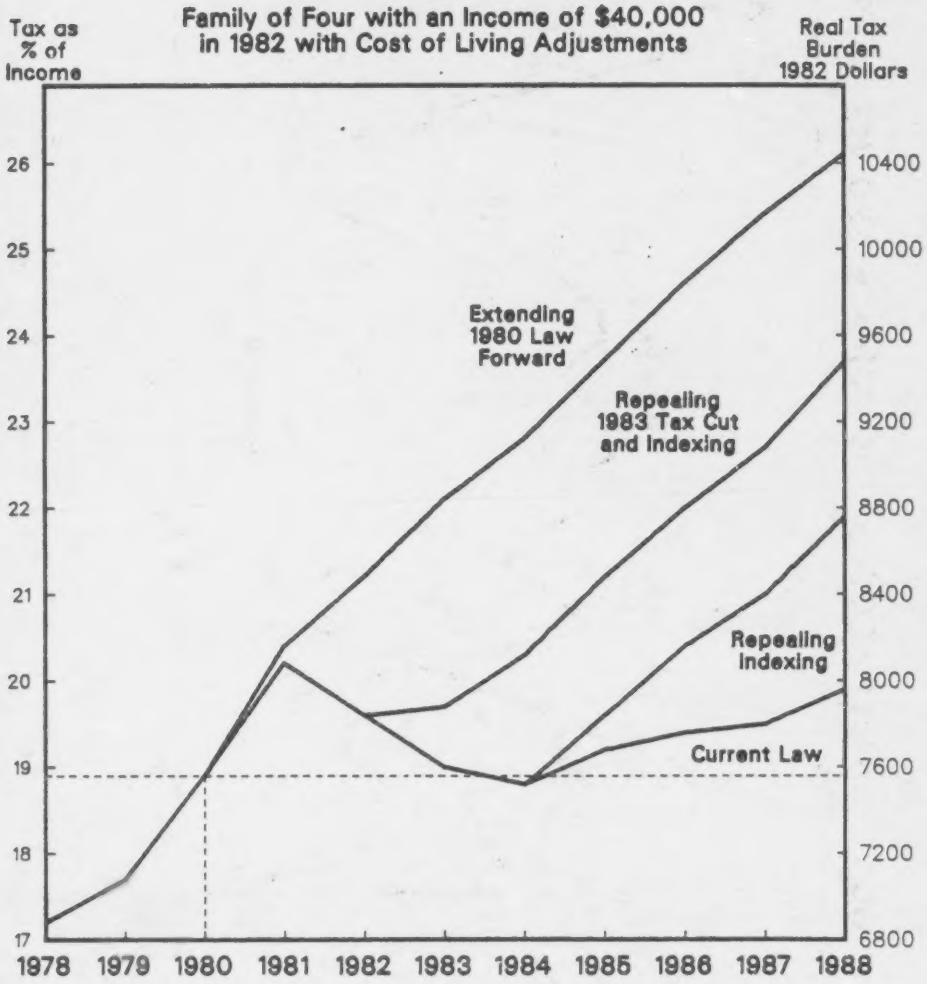
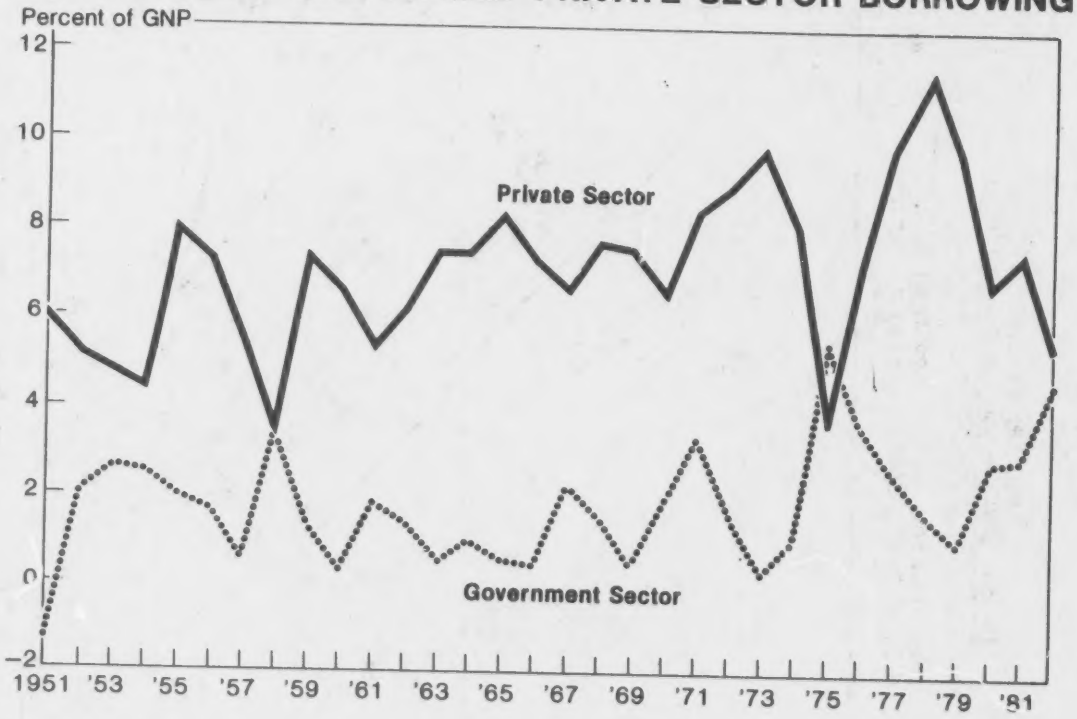


Chart VIII

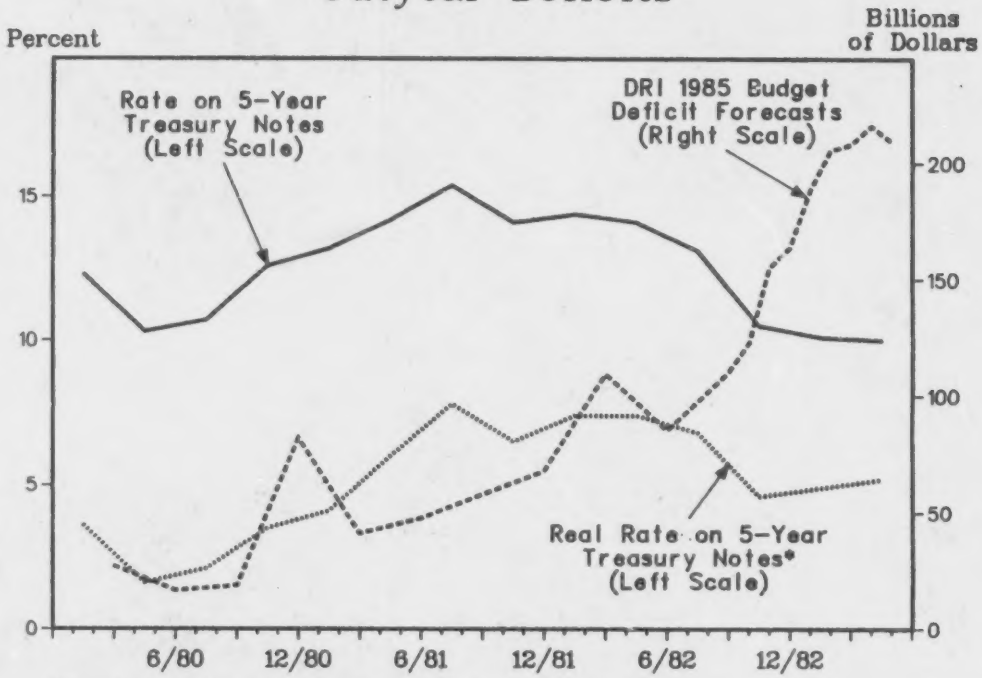
GOVERNMENT SECTOR AND PRIVATE SECTOR BORROWING



June 7, 1983-A244

Chart IX

Interest Rates and Forecasts of Outyear Deficits



*Nominal interest rate less DRI forecast of inflation through 1985.

Table I

Financing of Nonfinancial Corporations
(bil. of dollars, seasonally adjusted annual rate)

	Internal Cash Cover				External Financing		
	Internal Cash Flow*	- Capital Spending** Fixed	Inventories	= Financing Gap	Net Equity	Bond Financing	Shorter-term Debt***
1981	247.2	247.1	38.4	-38.3	-11.5	35.7	68.4
1982	237.3	268.9	-13.6	-18.0	11.4	40.2	45.1
1982 -III	244.0	264.4	14.0	-34.4	-1.1	50.5	56.9
-IV	235.4	271.6	-32.8	-3.4	32.6	57.5	-26.7
1983 -I (p)	245.2	271.1	-32.5	6.6	35.3	35.7	21.6

* U.S. internal funds, book values.
** Fixed investment includes mineral rights. Inventory investment before IVA.
*** All bank loans, commercial paper, acceptances and finance company paper.

Representative HOLT [presiding]. Thank you, Mr. Secretary. We certainly appreciate that view of where the economy lies today and where we are going.

I have always been very optimistic about what is going to happen if the economy does continue to grow at the rate that it is now with respect to the deficit. You touched on that a little bit. But I wish you would speak a little bit more to that. What is going to happen to the budget deficits in 1984, 1985, and 1986 if this strong pace continues? Will we not see really dramatic impact on the revenue part of it? You touched on that a little bit.

Secretary REGAN. If you want to have a rule of thumb, Congresswoman Holt, to try to keep in mind some quick arithmetic, you can take a look at what we are forecasting for gross national product for those years and figure that just under 20 percent of that will be tax receipts. You will find that you will come fairly close to saying that a 1-percent increase in gross national product would probably mean some $30 to $35 billion additional gross national product. If you take about 20 percent of that, you will figure out what the additional tax revenues could be.

Now from our point of view, we estimate that the upward revisions of our forecast mean about $15 billion in the first year and $15 to $20 billion of additional revenues in the outyears will come about.

If the Congress does not spend that, you can automatically see that that is how much the deficits would be lowered. In other words, by about $15 billion in 1984 and $15 to $20 billion in 1985, 1986, and on out.

Representative HOLT. Will not the economic growth have an impact on reducing the entitlements, in reducing the deficits in that way?

Secretary REGAN. What it will do—and we have figured that in of course—is work toward what is known as the full employment budget. Under the administration's forecast, the full employment area is hit in the 1987–88 level. That is somewhere around 6 percent, we figure, as full employment under modern definition. We have already accounted for that in our tax receipts. What will happen, though, if we keep inflation down is that entitlements, particularly in the COLA's, will stay moderate and therefore spending should be held down.

Representative HOLT. In the Wall Street Journal on July 15, Mr. Feldstein made a couple of conflicting statements. I do not know if you would want to comment on it or not, but I would like to hear your views.

In the article he said, "Even a very robust growth rate cannot solve the deficit problem." And then later in the same article he said, "Ideally the extra revenue will be forthcoming to reduce the deficits without a rise in tax rates because economic growth substantially exceeds our forecast."

Secretary REGAN. I think that what he was trying to imply, or at least what we in the administration are saying, is that if the spending can be cut, the rise in gross national product will be more than enough to give us sufficient revenues for the spending levels that we think are needed.

In my earlier testimony I indicated that we would like to bring spending down below 23 percent of gross national product, and we

have receipts rising even without tax increases into the 20-percent area. So the difference will equal a deficit of some 2 to 3 percent of GNP. That is a fairly good level, if we could achieve that 2 to 3 percent, over the next 3 or 4 years.

Obviously, what the President has said is that if it remains above 2½ percent, even with spending cuts, then he would go for some type of contingency tax for the fiscal 1986 budget.

Representative HOLT. Thank you, Mr. Secretary.

Congressman Hamilton.

Representative HAMILTON. Thank you very much.

Let me ask, first of all, a few questions about Mr. Volcker's testimony the other day. You apparently referred to it in your prepared statement.

Does the administration endorse the recent tightening of monetary policy that Mr. Volcker referred to and that you referred to in your prepared statement?

Secretary REGAN. As far as what has happened in the most recent past, that is, in the last month or so, the slight tightening by the Fed in the money supply has been something about which the administration has been slightly ambivalent. We recognize that the slight tightening brings about an increase in interest rates. You cannot have one without the other. But we do not want interest rates to rise so much that they choke off the recovery.

So we have gone along with a slight tightening of the money supply. We would not want, as did happen in 1981, a sudden choking off of the money supply, which invariably would lead toward a recession again.

Representative HAMILTON. I understand your comment to mean, Mr. Secretary, that you do in fact endorse Mr. Volcker's position.

Secretary REGAN. I have to add this proviso. I do not know what happened last Tuesday and Wednesday at a meeting of the Federal Open Market Committee, so I am not endorsing the program decided upon then until I know what it is.

Representative HAMILTON. I understand. But you are endorsing the action that occurred earlier—I think it was in May—by the Fed. That was a very close vote, as I understand it, in the Fed.

Secretary REGAN. According to the notes that came from the meeting it was a 7-to-5 vote.

Representative HAMILTON. And the minority in that vote felt that even that slight firming, as you put it in your prepared statement, would cause an increase in the interest rates.

Secretary REGAN. That is correct. And that has happened.

Representative HAMILTON. In view of all of the confusion that we have had about the discrepancies in the growth rates of the various monetary aggregates relative to their target ranges, do you think we need a new system of targets, either real interest rates or targets for nominal GNP growth? How do you assess that rather technical topic?

Secretary REGAN. That is a debate that will never be solved, in my judgment. I am not an economist. I am a financier. From my point of view, we need enough money to keep us going but not too much money. And having said that I would add that the method for achieving that goal is more of an art than a science.

Representative HAMILTON. Maybe that is why you are a financier and not an economist, Mr. Secretary.

Secretary REGAN. I would put it this way: You not only have to look at the money supply, but also at price levels, or you have to look at interest rates. You can't just focus on one thing and one thing only. My monetarist friends naturally are looking only at one level. Others would prefer that we target interest rates or that we target prices. I think you should look at all of them and make sure you know what you are doing.

Representative HAMILTON. Let me get your comment on one other suggestion Mr. Volcker made. He thought that the Fed Chairman's term ought to begin the year after a President takes office. I think he described it as being the least worst of several alternatives. Do you have any judgment on when a Fed Chairman's term ought to take place and how it should coincide with the President's term?

Secretary REGAN. I'm going to speak here as an individual and give you, Congressman Hamilton, my opinion personally, not that of the administration, because we have not developed an administration position on this issue.

I go back in history to how the Federal Reserve started, what the authors of the Federal Reserve Act had in mind, and what happened in the first 20 years of the Federal Reserve Act.

At that time the Chairman of the Federal Reserve was the Secretary of the Treasury just by virtue of his office. They also had a senior official who was appointed by the President as sort of a governor of the board. That changed under the difficulties that President Roosevelt and Carter Glass had and led to the change in the banking act. As a result, the administration in 1935 parted company with the Fed and the Fed remained independent.

We are the only Nation that I know of, particularly among the industrialized nations, that have a central bank independent from the elected government. Although the Bundesbank says that it is independent, it still is fairly close to the elected majority in the Bundestag.

I would say that the administration should have some control over monetary policy in order to see that it harmonizes with fiscal policy. Otherwise, the administration cannot be held responsible for what is going on; it could always cop a plea that somebody else was responsible, not they.

I think the electorate has a right to expect that the administration adhere to whatever philosophy it was elected to pursue and not have interference in that. Therefore, I personally would like to see the term of the Chairman of the Federal Reserve, if not coterminous, at least within a year of the election of a President.

Representative HAMILTON. I am very pleased to hear you say that. I concur with that view.

In listening to your testimony this morning and comparing it to Mr. Feldstein's recent article, I sense a different emphasis. You say in your prepared statement that "we urge that the budget be brought toward balance by economic growth and spending restraint, not by tax increases."

The administration has proposed a so-called contingency tax increase. I have one question about the chart that you showed us.

Secretary REGAN. Let me get that chart. It does not show the contingency tax.

Representative HAMILTON. It does not show the contingency tax. I wanted to clarify that.

Secretary REGAN. I believe this is the one you referred to. If the 5-percent contingency tax surcharge were added it would be right under that $4,500 line.

Representative HAMILTON. I appreciate that clarification.

The point I wanted to make in regard to your testimony and Mr. Feldstein's is that he seems to put more emphasis on the possibility of a tax increase; he talks often of a combination of reduced spending and additional revenue. I understand additional revenue can come from growth as well as from tax increases. But he says "coupled with such spending restraints should be a conditional rise in tax rates that would come into effect only after 2 years."

Is there a difference between you?

Secretary REGAN. There is no difference in administration policy. It may be a difference in emphasis or how it is stated.

I take you again back a little bit in history, Congressman Hamilton. I was a member of the "Gang of Seventeen." And you will recall that we tried to fashion a combination of tax increases and spending cuts. Even after the "Seventeen" fell apart there was still an agreement reached that we would have $3 of spending cuts for $1 of tax increases, and promptly passed a bill that would have revenues increase by $99 billion over the 3 years 1983, 1984, and 1985.

We never got the spending cuts. As I judge it now, it is somewhere in the neighborhood of 50 or 60 cents for every dollar of tax increases.

That is why now I am putting the emphasis on the spending cuts coming first; I would like to see the cuts first before the tax increases are enacted. If we can get those spending cuts, and if growth does not take us to where that deficit is below 2½ percent of GNP, then by all means we should raise taxes in 1985.

Representative HAMILTON. Mr. Feldstein also speaks about the "vocal group of vestigial supply side extremists" who claim that perennial deficits are preferable to tax increases. Are any of those vocal, vestigial supply side extremists in the Treasury Department, Mr. Secretary?

Secretary REGAN. There are several and they are well respected. I think that is hyperbole and an uncalled for remark.

Representative HAMILTON. One other question. You refer to the credit crunch problem that may face us down the road. If we get a stronger private recovery, does that not mean that the credit crunch will come sooner rather than later?

Secretary REGAN. It depends upon exactly how it comes about.

I noticed, by the way, that yesterday in the revisions to capacity utilization rates that we are now up to 74½ percent of capacity. If that figure starts to rise precipitously resulting in an upward revision to business plans for expansion in new plant and equipment, that could well happen. At the current moment, as we see it, there will be sufficient savings, particularly as a result of the tax cut that was just enacted in July, in order to accommodate both Treasury and what we see now as private demand for the year 1984.

Obviously it could happen if savings do not increase as fast as we think, or if business spending plans were raised. But at this moment we do not see it.

Of course, there is one other possibility, which I would welcome. That is that spending cuts for fiscal 1984 would be enacted that would cause us to have to borrow less at the Treasury.

Representative HAMILTON. Thank you very much, Congresswoman Holt.

Representative HOLT. Congressman Scheuer.

Representative SCHEUER. Thank you very much, Congresswoman.

It is a pleasure to have you with us, Mr. Secretary.

Mr. Secretary, you stated this morning that a little tax increase as we are coming out of the recession would be bad for the economy, or is bad for the economy. Yet you endorse the recent policy of the Federal Reserve's tightening of monetary policy. If a little tax increase is bad for the economy, why is a little tighter money and little higher interest rates apparently good for the economy?

Secretary REGAN. Well, you have to remember if you had a tax increase who would be paying for it. That money would be coming out of the pockets of consumers and savers. While it would, hopefully, be used to reduce the deficit, more probably, at least as recent experience would have it, more would be spent by the Federal Government. Money spent by the Federal Government does not do nearly as well in promoting economic recovery as money spent by individuals or corporations.

As far as money being taken out of the economy, what I think the Fed is trying to do is to prevent overheating before it comes. They see by this flash estimate of 6.6 percent real growth—which in the judgment of many people, including my own, is probably on the low side and probably will be marked up—that we are having quite a recovery. Therefore the Fed won't need as much money in circulation in order to accommodate the recovery. The recovery is already here and stronger than we had originally anticipated.

Representative SCHEUER. Mr. Secretary, the twin pillars of Reagan economics as well as Regan economics is the economy's presumed ability to boost investment and savings, particularly individual savings. A great deal of attention has been given to the fact that private domestic investment in 1982 was down 10 percent or over $50 billion from 1981, that it even slumped below the 1979 level of $423 billion. I think less attention has been paid to the behavior of individual savers under your economic program and that of the President.

In the last two quarters, on a seasonally adjusted annual rate basis, personal savings peaked in the fourth quarter of 1981 and stagnated at a 15-percent plateau below that peak. As a share of personal disposable income savings reached 6.9 percent in the third quarter of last year, well below the 8.5 and 8.6 shares scored in the middle 1970's, and the first quarter of this year personal, private savings slumped to only 5.9 percent of income.

We have seen record high interest rates again over the past several years, and they are beginning to rise only a couple of months after the onset of the recovery. And yet despite this unexpected and added stimulus to savings, your program has not enabled us to match past private sector savings performances.

What is your explanation of why so-called Reaganomics has not delivered on its promise to increase the level of private sector individual savings?

Secretary REGAN. Let us take the two sectors—first consumer and then business. I think as far as consumers are concerned, they have been spending rather than saving particularly because of automobile sales incentives that were so enticing as to make them want to buy automobiles. Automobile sales are running ahead of what most economists thought they would be. This has to be one of the explanations. Rather than save, they have been buying.

The other one is, believe it or not, I think those figures are suspect to a certain degree. For example, the amounts that go into social security are not included in that net private savings. I think a lot of individuals rely on that rather than save individually for their own retirement, as they have to do in Japan.

The third thing. When it comes to business, we were in a recession last year, so business did not have much in the way of after-tax profits last year. I think you will see that changing this year. Depreciation, which represents a cash flow in business, is part of gross savings and should be taken into consideration. Business has been financing itself out of its cash flow. I think it will be able to do that quite well during the remainder of this year.

Plus, of course, you have to consider the investment in the stock market. Sooner or later that is going to be recognized. There are over $500 to $600 billion of added values in the stock market over the last 6 or 7 months. Sooner or later that has to be added in to the total stock of wealth in the country.

Keeping inflation down will be another way to do it. If you think that inflation is going to stay down you will save; if you do not, it will not.

I think the people will gradually realize that we, the administration and the Congress, working together can keep inflation down in the outyears. If that is so, savings will again come back in vogue.

Representative SCHEUER. You mentioned that people have been consuming rather than saving. Does this lead you to give any consideration to some kind of consumer based tax to shift relative preferences away from consumption and toward saving?

Secretary REGAN. It is too early for that, Congressman Scheuer, at this particular time. I would not want to see a consumption tax in either 1983 or 1984, but in 1985 it is a subject well worth considering. Very definitely.

Representative SCHEUER. Thank you very much, Mr. Secretary.

Thank you, Mr. Chairman.

Senator JEPSEN [presiding]. Mr. Secretary, capital spending remains weak. Why are not the administration's increased incentives for investment working? Or are they working and we are not having accurate reports?

Secretary REGAN. Well, they are working in certain areas. There has been a lot of spending going on for high-tech items such as office equipment, computers, things of that nature. Not the traditional new factory in the 1940 or 1950 sense. Capital spending in that sense, new blast furnaces, et cetera, is something that really lags the whole economy

and might be expected to come about as capacity utilization in manufacturing continues to increase.

Yesterday the revised figures came out and showed a very healthy increase in capacity utilization, which is now up to close to 75 percent. As that passes over 80 percent, which it probably will either in this quarter or the final quarter of this year, business capital spending plans are bound to increase.

So I think that it is too early in the recovery to see those increases yet. But they will surely come about the longer this recovery continues.

Senator JEPSEN. As you know, Mr. Secretary, I have been interested in reducing the holding period for capital gains. I am firmly convinced that this would help stimulate investment activity, and it would certainly be a revenue raiser. For this reason I have been waiting for Treasury to finish its study of the 1978 capital gains tax cut for some time.

In January you told this committee that the study would be available shortly. Can you give us a firm date for the study's completion, because I would like to call a hearing at that time to examine the report's conclusions so we can move on with this.

Secretary REGAN. I am very embarrassed by this, Mr. Chairman, because that is one of the things that I asked about, before coming to this hearing: What the hell happened to that study? Well, it seems that the same people who were going to do that analysis in the meantime also have been working on the 1981 and the 1982 tax acts, trying to get out regulations, working with the IRS, and therefore got bogged down.

Let me put it this way. When you return from the August vacation you can prepare your hearings. We will be ready.

Senator JEPSEN. Thank you.

What is your outlook, Mr. Secretary, for long-term interest rates over the next several years as of today?

Secretary REGAN. We expect they will be down by the end of this year from where they are now, and our official forecast going out into the 1986 period would have them down about a point and a half on the prime from where they are now.

Senator JEPSEN. During my tour of parades and visits in Iowa on the Fourth of July weekend the most commonly asked question of me concerned rising interest rates and deficits. This has led to a big argument over what path the Federal Reserve Board should be taking.

What do you think is the proper rate of money supply growth?

Secretary REGAN. I am leaving that to the Fed, just as I would not want the Fed to tell me how to raise money, I do not think I will tell them how to conduct their affairs. But what we in the administration have asked of them, and what they have promised to do, is to try to give us a slow, steady growth in the money supply.

I get tired of hearing myself say that and trying to quantify it. What we are saying is that certainly 14 percent on M_1 in the months ahead would be too much money growth. We think that there should be less than that. The Fed agrees and they have tightened in order to try to get that rate of money supply growth down.

As it comes down on M_1, M_2 and M_3 will also recede somewhat, although both of those figures have looked a lot better.

I would say that if the Fed just drew a line and tried to stick within its original targets from now until the end of December they would be in good shape.

Senator JEPSEN. Mr. Secretary, I have been hearing a lot of talk saying that the recovery is only temporary and that different forces will prevent us from sustaining current growth levels.

In your opinion, what is the greatest threat to further economic growth and recovery?

Secretary REGAN. Return of inflation. I think that if inflation returns, our country would go right into the tank again from an economic point of view. We should always keep in mind any steps that can be taken to keep inflation down. I do not think we will ever get negative price growth, although we had it for a short period of time earlier this year. I do not think that that is achievable over the long term. But I do think that a low rate of inflation, 2 to 3 percent, is achievable in this economy. If we can keep inflation in that range, we can keep the recovery going.

Senator JEPSEN. I believe that the inflation rate during the first quarter of this year was the lowest in 18 years.

Secretary REGAN. That is correct.

Senator JEPSEN. Why is it then, that public opinion surveys from around the country indicate that the general public does not realize that there has been a dramatic reduction in inflation? What can we do to apprise the general public that we have had a great victory against inflation and that the administration should get credit for it?

Secretary REGAN. I think what has happened is that people, whether they are buying groceries, automobiles, or what have you, have not seen price reductions. They have seen a lessening in the rate of increase in prices, not a reduction in prices, and they do not equate that with inflation dropping. If something goes from $1.69 to $1.72, whereas it might have gone from $1.69 to $1.89, a person still sees prices going up. I think that is primarily why the average person may have missed seeing what inflation has done.

But as I tried to point out in my first chart, real wages are starting to increase, and I think that is where people will really begin to see that their paycheck is stretching further these days. That's where recognition that something has happened will take place. The fact that inflation is down will be gradually realized.

Senator JEPSEN. Just to make sure that the record is very clear on this, is there any source, any group that you know of or have heard of that says that inflation is not down? Don't all experts on this matter agree that inflation is the lowest it has been in 18 years?

Secretary REGAN. Yes, Senator. They all agree that inflation is down now. What people are very much afraid of is what is going to happen 1 year, 2 years, or 3 years from now, and they usually couple that with concern that we will continue to have these large deficits.

Senator JEPSEN. I have other questions, but I will just ask one and then yield to the distinguished vice chairman and come back.

A real gross national product growth above a 4-percent level is necessary before a substantial reduction in the unemployment rate can occur. Do you agree or disagree with that statement?

Secretary REGAN. Above 4 percent?

Senator JEPSEN. Yes.

Secretary REGAN. Above 3 or 4 percent?

Senator JEPSEN. Four percent.

Secretary REGAN. Three percent will told the line and 4 percent will start reducing unemployment.

Senator JEPSEN. So it is a correct statement then that real gross national product growth above a 4-percent level should result in some reduction in unemployment?

Secretary REGAN. Actually, growth above about 3 percent would normally reduce the unemployment rate.

Senator JEPSEN. Would you explain for the committee the relationship between real gross national product growth and the unemployment rate?

Secretary REGAN. An approximation of the general relationship is that above that roughly 3 percent real growth rate you should have additional growth in GNP of about 2 percent in order to have a 1-percent reduction in the unemployment rate. So if you were to have, let us say, a 6-percent increase in real GNP for a year you could expect that the unemployment rate would be down about 1½ percentage points.

Senator JEPSEN. Thank you.

Representative Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Mr. Secretary, you probably know that this session we are having today is the first in what we hope will be a series of quarterly assessments of the economy, and we appreciate very much your cooperation this morning. We would like to get quarterly judgments with regard to inflation, growth, and employment, and you are very helpful in your testimony. I hope that we will have your cooperation and the cooperation of the administration in the future with regard to those hearings.

Secretary REGAN. We will be glad to do that, Mr. Hamilton.

Representative HAMILTON. I want to thank the chairman, Senator Jepsen, for having this kind a of session, because I think it will be helpful to the Joint Economic Committee as well as to the country to have some idea of these quarterly changes.

Secretary REGAN. Could I make a suggestion, Congressman Hamilton, on scheduling?

Representative HAMILTON. Yes, indeed.

Secretary REGAN. If you could make it the last week of the month. By that time we would have more of the figures coming out. As it is now, we are talking here on Tuesday. On Thursday we will get the GNP estimate, for example, for the last quarter, the official figure rather than the first pass at what real GNP would be. We would have a better fix on the unemployment rate and the like. So later in the month following the end of the quarter would be a great time to schedule it.

Representative HAMILTON. That is a good suggestion, and I think we can follow that, with the chairman's permission, of course.

Let me return to your comments about inflation. Do you think the policies are now in place to deal with the resurgence of inflation if it occurs?

Secretary REGAN. Again, I am not wishing to pick on the Congress here, but the one thing I worry about is excessive spending. I think that the Fed is aware of what it has to do in the monetary field and is trying now to snug up a little bit in anticipation of too much money growth and concern about keeping inflation down. I think that business people, including labor, have seen what the ravages of inflation are, and I think, as a result, they are much more sensible about wage settlements and the like. I am very pleased with what has been happening in the first 6 months of this year.

Representative HAMILTON. You do not see any need for any action by the administration or the Congress now to deal with this potential inflation problem other than the things that you have already mentioned in your testimony?

Secretary REGAN. No. Coming to prices, prices have remained moderate. I do not see in the commodity markets any indication that any of the base metals, or indeed any of the edible products, are getting out of hand in a way that would indicate future inflation.

Representative HAMILTON. In the period from 1974 to 1976 you had a very rapid drop in the inflation rate, and then after 1976 you had growth rates that were less rapid than those that are now projected in this recovery. Yet in that period you had a very sharp acceleration of inflation.

I think your comment about the potential of the inflation problem is on target. I am concerned that we are not sufficiently concerned in the Congress and in the country about the possibility of inflation rearing its ugly head again.

Secretary REGAN. I think you can actually see that in some of the rates of interest that we are paying on medium-term and long-term bonds right now. They are unusually high. Treasury is paying 11½ percent for 20- and 30-year money. That would indicate that somebody is worried about inflation out there, because that certainly is much higher than has been typical in the past, as far as real rates of interest are concerned.

I think the worry is that we in Government will not get our act together as far as spending is concerned and we will keep demanding a larger portion of gross national product for the Federal Government, thus crowding out the private sector and thereby reheating inflation. I think that is the big worry at this particular moment.

Representative HAMILTON. One other problem that has concerned me and many others is the unusual persistence of long-term unemployment, which today is at a historically high level. Are there any policy initiatives that are necessary to deal with that problem at this point?

Secretary REGAN. I think there are some that can be taken. We have a certain amount of what is referred to as structural unemployment, which means that there is a mismatch of jobs and skills. In addition, there are more women in the work force today which probably raises the natural rate of unemployment. That is one reason why I do not think the unemployment rate comes down as fast perhaps as could be expected, because more and more people join the work force, and therefore, unless you have more and more jobs, the rate of unemployment stays up.

We also have dislocation coming about, industries that will not rehire as many people as they formerly did. I am talking here about the basic industries—automobiles, steel, chemicals, and the like. I think

what the Congress did last year in the jobs bill is what is going to have to be done on a massive scale: more reeducation of workers, as well as relocation of workers in order to put people where the jobs are or will be.

Second, I think that we need a massive educational change in order to do a better job in the United States of training people for the work that will be available. I do not think that our schools and colleges are putting the right types of skills at the command of those who have to employ them later in industry.

With the wave of immigration that we have had, particularly of Spanish-speaking peoples and the like, we are going to have to do a lot better job at teaching both English and numerical skills. As an employer, I could see that time and time again in New York City. People simply were not able to put their native intellect to work because they could neither speak nor use arithmetic correctly in order to get the jobs that were available.

I think that we have to retrain managers also. That is one of the good features—if there is such a thing as a good feature—coming out of a recession. Our managers in this country simply did not know how to manage well enough to cut costs and keep costs down, and they merely passed costs on. That, of course, added to our inflation problem. They had a rude awakening in 1981 and 1982. I think that managers have to be retrained for that type of thing.

And then again I think that we have to start thinking in terms of where we are going as we enter the 21st century. A lot of our economic thinking is still directed to the smokestack industries that we used coming out of World War II. We have to rethink how we are going to manage this economy as we get into the 21st century. We have to think about the type of economy we will be having then rather than the type of economy we had back in the 1930's and 1940's.

Representative HAMILTON. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

This recovery that we have seen—and it is very encouraging to all of us—began 4 or 5 months ago. Yet in only the second quarter of this recovery we have seen an increase in interest rates which threatens to reduce the flow of savings that will fuel our economy. I think you are probably as concerned about that as I am. A number of private economists have expressed their concern that interest rates will be rising this fall and winter. It is quite conceivable that these people like Alan Lerner and Alan Greenspan are correct that the surge usually seen in business investment during recovery as a concomitant part of the process may not occur, and that if this happens, rising interest rates will keep the dollar high, which would be a catastrophy to our country in terms of our ability to sell our goods and services abroad.

It could be that the rise in interest rates can be traced to the Fed's decision to exercise restraint in money growth in the face of massive Federal borrowings.

Well, all of this gets us down to the Fed's policy of restricting credit. Do you believe that their policy of credit restraint threatens the recovery, particularly the last quarter of this year and in 1984?

Secretary REGAN. If the Fed stays on the course, that is with just a slight tightening of money supply, I do not believe there is a danger of a large increase in interest rates. To the contrary, interest rates should drop, because people are reassured that the Fed will not allow too much money to be in circulation nor inflation to be reignited. It is the fear of inflation, supposedly, that is driving interest rates.

That being the case, interest rates should come down if the Fed's actions are, as they say they will be, just a slight tightening.

Obviously, there are many sarcastic cracks about the Fed, that they have only two speeds—too fast and too slow. If they go too slow on the money supply, then they will choke off the recovery; too fast and will drive interest rates way up because of fear of inflation.

So they have to go this narrow tread.

Again I come back to that same old theme. It would be helpful to the Fed and to the economists who are watching the Fed, if they were to see the 1984 deficit coming down, particularly with the recovery, and the 1985 deficit coming down even more. Most people now have built into their expectations, as I tried to indicate on chart IX of my prepared statement, the DRI forecast of deficits of over $200 billion still in 1985. Well, if they could be reassured that the deficit will be closer to $150 billion—God knows that is large enough—then the Fed would have to be less concerned about what crowding out by the Treasury might imply. Therefore, they could take a slightly easier course.

So I think we have to blend fiscal and monetary policies very skillfully over the next several months in order not to abort the recovery.

Representative SCHEUER. Do you see any realistic likelihood that over the long pull we are going to get our deficits down much below the $200 billion mark that everybody seems to be predicting for as long as the eye can see?

Secretary REGAN. I think it is entirely possible, and that is without cutting out really needed programs. I think that if the Congress takes a sharp look at where some of the increases have occurred, they will see that with the recovery coming about, we really do not need as big a program in some areas. They can try to pare back in these areas—and also, in the one where Senator Jepsen has a problem, our farm program. For instance $22 billion of CCC outlays were needed this fiscal year. Hopefully, they are not going to be needed in the years ahead as the PIK program comes about. That would be one possible reduction.

So if we could reduce some of the entitlements, reduce some of the domestic spending, and reduce some of the farm subsidies, I think there is a good chance we can get those deficits down without really hurting in too many areas.

Representative SCHEUER. Mr. Secretary, you just told us 5 minutes ago how important the training programs were for people who could not read, write, and count. And I could not agree with you more. These are problems that are going to rend American society apart.

On the front page of The New York Times yesterday there was an article that talked about the astronomical increase from 10 or 12 percent to 47 percent of the percentage of infants who were born to black

families with a single head of family, a female head of family. By all the statistical criteria that is a generational indication of poverty for decades if not generations to come.

You put your finger on it not 5 minutes ago as being a structural problem that does not respond when the tides go out. You are a man of great compassion, otherwise you would not have picked out those very programs that you did pick out that are structural. That problem is not going to go away. That very problem mentioned that 40 percent of black adult males are unemployed today. They are not unemployed because 40 percent of the American public is unemployed or because 40 percent of American adults are unemployed; they are unemployed for very special reasons that are endemic to that particular group and that particular pathology that you are quite well aware of. You just pointed it out.

And this is what makes it very difficult for us to cut back on these entitlement programs.

You, A, have the mothers, and B, you have the kids who are going to have a terribly hard time, and C, you have the black males who need—well, we do not really know what they need, because we have really failed to give them what they need, and that is sort of a truism because we are faced with the appalling, tragic fact that 40 percent of them are unemployed. These are black adult males in our society.

If you take your utterly decent and compassionate statement of 6 or 7 minutes ago and you put it along side your statement of how we are going to reduce deficits by saying, well, the tides are rising so we can cut down on the entitlement programs. For the life of me, while we have these structural problems of unemployment facing us, I do not see how we can, and I wish you could explain to us how we could, and I wish you could explain away this apparent inconsistency in the space of 10 minutes in your own testimony, because you are a decent, fine, sensitive, compassionate man and you are well aware of the problem of structural unemployment.

Secretary REGAN. I do not think that there is an inconsistency in what I said, Mr. Scheuer. I do think that what we need to do is to refocus some of the spending of the money that we have now into retraining and focus it more clearly on the large problems. That is what I am advocating, not just throwing money on top of money at the problem, but refocusing and reshaping our thinking of what is needed in the future.

In the field of medicine, for example, I think both you and I could agree that medical costs are really rising much too rapidly. I think there is a lot that can be done to hold down those costs, particularly in Federal programs, third-party pay programs and the like.

So we can hold some of these budget programs firm, and not let them rise over time as the economy improves.

I think we could all agree that there is no need to spend as much money with an improved economy as there is with an economy that is weak. And that is all I am saying. If current budget levels are maintained instead of continually rising out into the future, the rise in tax receipts due to the recovery will result in a reduction in the deficit. That is an entirely plausible scenario.

Representative SCHEUER. Mr. Secretary, I appreciate your comments. My time is up, but I just cannot help making one last footnote to your comment about medical costs.

Until our society, including this administration and prior administrations spanning the last 10 or 15 years since I have been around here, until they get over their preoccupation with tertiary hospital beds at $350 or $400 a day and their preoccupation with high technology approaches to health care or sickness care and their feeling that our health outputs are going to be saved by CAT scanners and open heart surgery and organ transplants, and until they come to the understanding that the only way we are going to improve our health output and the only way we are going to get a handle on health costs is for them to engage in a vast preventive health program to teach the American people that we have met the enemy and he is us, and that we, each of us, have to take control of our own health in terms of ingestion of tobacco or dangerous drugs, of proper diet, of proper exercise, avoidance of violence, that each of us controls our own health outputs to an enormous extent, and until some administration begins to get a clue to that simple theory and stops relying on inputs of high tech sickness care and begins to think about preventive health care I do not think we are every going to get our health costs under control and I do not think we are ever going to see a significant improvement in the health of the American people.

I appreciate your testimony very much. As always, you have been very forthcoming and instructive.

Thank you, Mr. Chairman.

Senator JEPSEN. Thank you.

Mr. Secretary, we will wind this up in a couple of minutes.

I want to put a disclaimer on this next question, because I think it belongs in Ripley's Believe It or Not column, and it is not in any way related to me or my beliefs. I saw in the Sunday paper a column entitled "Let's Spend Our Way Into Real Recovery." Some economists are advocating increasing government spending to maintain the momentum of the economic recovery. Do you see any basis for this view? I do not. But maybe I am missing something.

Secretary REGAN. Mr. Chairman, I think I am pretty good, pretty clever and so forth, but I will be darned if I think I can spend a person's money better than that person can spend it for himself. I think we in the Federal Government should do a lot less spending of other people's money. If we would let other people spend their own money, we would be a lot better off in the economy. I do not agree with that economist that we Federal bureaucrats should spend money for other people.

Senator JEPSEN. I am glad to hear that.

You indicated that Thursday you are going to get something more of a firm flash. This will be the big flash, will it? Would you care to give any indication of what we might anticipate from the release?

Secretary REGAN. To be on the safe side, Mr. Chairman, I think I will just say it will be higher than 6.6 percent.

Senator JEPSEN. Higher than 6.6 percent. That is good news.

Well, that is a good way to recess the committee.

[Whereupon, at 11:30 a.m., the committee recessed, to reconvene at 11 a.m., Thursday, July 21, 1983.]

GNP AND ECONOMIC OUTLOOK

THURSDAY, JULY 21, 1983

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 11:25 a.m., in room 628, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen and Representatives Hamilton and Lungren.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and Paul B. Manchester, professional staff member.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Last Tuesday, Secretary Donald Regan gave the committee an optimistic report on the economy and predicted that the second quarter real gross national product figure would come in above 6.6 percent, issued as a flash estimate last month.

The Secretary was right. The figure released just an hour ago shows that the real gross national products grew at a whopping rate of 8.7 percent in the second quarter of 1983. I commend the Secretary for his acumen. Except for those who prepared the numbers, and they are sworn to strictest confidentiality, no one knows the gross national product numbers until they are released.

In my opening statement at Tuesday's hearing, I cited some of our good economic news. I will not take time to repeat it here, except to say that this recovery is, indeed, very broad-based, as well as strong. Except for our foreign trade balance and a still too high, but declining, unemployment rate, there is really no bad economic news out there.

Even with regard to the job situation, employment is booming. On a seasonally adjusted basis, the economy has created 1.7 million jobs since January. That is 4½ million jobs on a raw, nonadjusted basis. This is a remarkable record. Were it not for the large increases in the labor force, the unemployment rate would be falling more rapidly. Even so, the eight-tenths of a percentage point drop in unemployment since last December is the largest drop in the first 6 months of recovery in 33 years. The unemployment rate will be below 10 percent for the rest of this year and I expect it to be close to 8 percent by the end of next year.

We look forward to the testimony that will be given today. We want to learn where the economy will be heading the rest of this year and

next year. As people serving in public office, we are naturally interested in the expected state of the recovery in November 1984. But, as statesmen, we also want to know how things look for our country in the out-years, 1985, 1986, 1987, and 1988.

To give us the word, we have with us today two outstanding economists, Lawrence Chimerine, chairman and chief economist of Chase Econometrics, and Richard Rahn, chief economist of the U.S. Chamber of Commerce.

Gentlemen, we look forward to your testimony today and I would now yield to the very distinguished vice chairman of this committee, Congressman Hamilton.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative HAMILTON. Thank you very much, Mr. Chairman. Let me join you in welcoming these distinguished economists before our panel this morning. The figure released an hour ago revealing that the real GNP rose at an annual rate of 8.7 percent last quarter is certainly good economic news. That is the fastest growth since the first quarter of 1981. It is not unprecedented. We have had rates that high for individual quarters 19 times since 1950. There are, as your prepared statements point o , a number of clouds on the horizon that we have to be concerned about, as there always are in economic statistics—the interest rates, the credit crunch, the high value of the dollar, the international debt situation, and others.

But we're very pleased to have you with us this morning. We look forward to your testimony.

Thank you very much, Mr. Chairman.

Senator JEPSEN. All right, gentlemen, I would recognize and suggest that we start with Lawrence Chimerine. I would advise you that your prepared statements will be entered into the record in full. So you may proceed in any way you so desire.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS, BALA CYNWYD, PA.

Mr. CHIMERINE. Thank you, Mr. Chairman. I am pleased to be here and I have submitted a rather lengthy prepared statement for the record which I will try to briefly summarize.

I would like to confine my remarks to two issues. First, in view of the number that was released this morning, which, as you indicate, shows a very strong growth rate, what is the outlook over the next year or so? Is it likely to continue very strong? Is the recovery in jeopardy and so forth? And second, I would like to discuss the policy situation and in particular, what is necessary, in my judgment, to make sure that this recovery does continue for several years because I think it is extremely important to recognize that, even with the sharp increase in second quarter GNP, the economy is still relatively depressed. It is still operating at a very low level and we need several years of steady growth in order to get back to a healthy and vigorous economy.

I think the policy issue thus becomes very critical.

Let me begin with the current state of the economy. It is my judgment that the recovery which is now about 6 or 7 months old has resulted from three or four factors which provide very strong underpinnings. These suggest that it is likely to continue for the rest of 1983 into 1984, and very likely throughout all of 1984. These major forces are as follows:

First, there has been a sharp decline in the inflation rate, as everybody is aware of, particularly reflecting improvements in productivity and a flattening out in oil prices after the sharp increases during the 1970's. Inflation has dropped from about 14 or 15 percent in 1980 to where it is now in the 3-to-4 percent range, and, in my view, this is a major factor leading the recovery process, just as the acceleration of inflation was a particularly significant factor which ultimately produced the economic stagnation that we have lived through in recent years.

Second, the financial position of most families has improved dramatically during the last year or two and it is still improving very rapidly; this has significantly increased the ability to spend on the part of most consumers. Now, of course, those people who are directly affected by unemployment would not fit into this category. But for most everyone else, the decline in the inflation rate, the growth in purchasing power or real incomes—in many cases, for the first time since the early 1970's—the increase in the stock and bond markets which has increased the value of household financial assets, the sharply reduced debt burden, and even an increase in housing prices in some areas, which, of course, represent, the major form of savings for many people, all of which, when put together, indicates a significantly improved financial condition for most families in the United States. And the decline in the layoff rate in recent months, plus the rise in the stock market and lower interest rates have bolstered consumer confidence.

So we are in a situation now where both the ability and willingness to spend have improved. That is a major factor in the recovery process.

Third, the amount of fiscal thrust in the economy, coming principally from the military buildup and from the tax cuts, is almost unprecedented. Certainly, it is larger now than at any time since the 1960's and increased fiscal stimulus is also a factor in the current recovery process.

Fourth, as you all know, during 1982, the stagnation or recession was prolonged by the severe cost-cutting which characterized the U.S. economy. Most companies were liquidating inventories, delaying capital spending, laying off workers, cutting wages and so on, all of which were designed to cut costs and stabilize profits after the sharp declines in recent years. A lot of that has now passed—at least it has diminished significantly. We have had a significant reduction in the amount of new cost-cutting actions and, in particular, we have moved away from that period of massive inventory liquidation in 1982 and early 1983. The recovery is now, in part, being fueled by a shift away from those two factors during the previous period. And finally, on top of these forces that I just described, we had a sharp decline in interest rates during 1982. Both long and short rates dropped about 4 or 5 percentage

points, and that has been an additional factor in the recovery process.

These are very strong underpinnings, particularly for the consumer sector. Not only are consumers experiencing an improvement in the ability to spend, and in their confidence, but, as I think everybody is aware of, there is a strong pent-up demand for many goods and services because many families have had to cut their living standards in recent years. So there is a lot of pent-up demand that can be met if financial conditions permit in the next several years.

Nonetheless, while these are strong underpinnings, and while they suggest that the recovery will continue, I would caution the committee not to extrapolate the second quarter statistics because, in my judgment, we are going to see a significant deceleration in the rate of recovery later this year and in 1984. Unlike the 8-percent plus growth rate in the second quarter, by the end of this year, the economy will likely to be growing in the 4- to 4½-percent range, still a good recovery, but certainly not as buoyant as the second quarter numbers would indicate.

I think that is the case because there have been a number of factors recently which have exaggerated the recovery. They are somewhat transitory, and I will run through them very quickly.

First, the shift in inventories away from liquidation toward a more neutral position is fundamentally a one-time charge. That won't be repeated. I think we have already gone through that. It is unlikely we are going to get lots of inventory accumulation, particularly with high carrying costs.

So my feeling is that that factor will not contribute as much to the recovery process later this year as it did earlier.

Second, we had a sharp rebound in housing during the first half of 1983, almost a doubling from where housing was toward the end of 1982. I think that is now in the process of leveling off and, in fact, we expect housing starts later this year to actually fall slightly from where it has been in the last several months.

This is not a return to the extremely depressed levels of 1981 and 1982, but it would not be quite as buoyant as we had in the last several months. Both multi-construction or apartment construction and single-family construction will weaken slightly. With respect to multiunits, there has been a significant amount of overbuilding in recent months, particularly in places like Texas, some of it fueled by large amounts of available financing. But vacancy rates have now begun to rise. The absorption of new units has slowed down dramatically and, in our view, this will lead to some reduction in apartment construction later this year.

And, with respect to single-family construction, that part of the market has been fueled principally by first-time buyers who have been buying smaller, starter homes this year. A lot of that pent-up demand has now been used up and particularly in view of the recent increase in mortgage rates, a large number of first-time buyers, and American families, in general, are still being priced out of the housing market.

So I think we will also see single-family starts level off and actually edge down slightly later this year.

Third, the consumer spending surge, even though it reflects the favorable factors that I mentioned a moment ago, has been a little bit

more rapid than I think is sustainable, principally because it has resulted, in part, from a sharp decline in the saving rate. Some of that, I think, is because consumers began spending the tax cut that they just received somewhat in advance. I expect to see consumer spending continue to grow and lead the recovery process, but it will grow more slowly during the next several months than it has in recent months.

Fourth, there are still two or three major weak spots in the economy, exports being the primary one. Export markets remain tremendously depressed, primarily because outside of Germany, the United Kingdom, and Canada, the world economy has not improved yet. Two, the dollar remains extremely overvalued. And three, we have not yet seen the recession in Latin America, and the austerity measures designed to reduce imports, show up in terms of their full impact on U.S. exports. So that will continue to hold down economic activity in the United States.

Municipal governments remain in a very serious financial crisis—in most cases are continuing to raise taxes and cut back spending. Investment spending is still flat, and not likely to begin improving until later this year. The PIK program, of course, will cause a sharp decline in farm output later this year and in some related industries—chemicals, fertilizers, and so on.

When you put it all together, therefore, we are going to see a continuation of the recovery process, led by consumer spending. But, as I said earlier, it is going to slow down in terms of rate of growth from what we have seen during the past 3 or 4 months.

I do not view the recent increase in interest rates as too alarming. I think it is an additional element that will prevent a more vigorous recovery later this year and in 1984. But it is not likely to abort the recovery if it doesn't proceed any further, primarily because only about 20 percent of the decline in rates in 1982 has now been reversed. They're still considerably lower than they were previously.

Second, a lot of the thrust in the economy, the military spending, consumer spending for nondurables and services and so on, are not really closely related to interest rates. So I think it will not jeopardize the recovery process.

How do we make sure that we keep this recovery going for several years? In my judgment, about the only thing that could end the recovery process sometime in the next 2 or 3 years would be if interest rates rose considerably further from current levels. And, in my judgment, the best way to avoid that is to continue the shift in the policy mix that was begun in 1982, away from an extremely restrictive monetary policy toward a more accommodative approach and, at the same time, away from the excessive amount of fiscal stimulus which, in my view, we will have in 1985 and beyond, toward efforts to reduce Federal deficits and fiscal stimulus in those years.

If we do that on the policy side, we will prevent higher interest rates, in my judgment, this will mean a continued recovery process for several years at least.

I might make one last comment before I finish. On the fiscal side, it is clear that the first priority should be to slow the growth in spending. But in my judgment, based on the analysis that we have done at Chase Econometrics, it is virtually impossible to put future Federal deficits

on a downward trend without some adjustments on the revenue side. This will mean delaying or offsetting a significant fraction of the additional tax cuts that are now scheduled to become effective during the next several years.

I do not think the acceleration in the economy will close the deficit gap, either, primarily because it will not continue to grow at this rate and also because there are other factors that are pushing the deficit in the other direction—particularly higher than expected cost of farm programs, the repeal of interest on withholding and dividends, and a number of other factors as well.

In my judgment, the deficits will continue to be in the $200 billion-plus range in the 1980's, and will probably even rise further, even with continued economic recovery. The only way the deficits can be reduced to insure recovery is by adopting spending cuts and tax changes to put them on a downward path during the years ahead.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Joint Economic Committee. I will focus my remarks today on the economic outlook and related policy issues. In sum, I believe that the recovery that is now about seven months old is likely to continue for the remainder of 1983 and into 1984, although the rate of recovery will slow considerably from recent months. Thus, despite the sharp growth rate during the second quarter, the recovery is likely to be relatively moderate on average. The outlook for the remainder of 1984 and beyond depends principally on interest rates—any significant rebound in rates above present levels would likely slow or stop the recovery within six months thereafter, despite the fact that most other underlying forces remain favorable for continued recovery. In my judgment, preventing higher interest rates and, in fact, encouraging somewhat lower rates, will require further adjustments in the policy mix. This should include additional expenditure cuts and tax increases designed to reduce future deficits as well as a continued accommodative monetary policy.

INTRODUCTION

The recovery which began at the end of 1982 followed almost four years of economic stagnation, during which real GNP was essentially flat and industrial production dropped sharply. The long period of stagnation in turn contained three different stages. Stage 1, which characterized approximately the first half of that period, was caused by significant declines in consumer spending in response to a sharp deterioration in the financial position of most American families during the 1970s. Stage 2 of economic stagnation took place in 1981 and early 1982, when the dominant factor which continued to exert downward pressure on the economy was record high interest rates caused by the fiscal program enacted at that time, which will produce extremely large and rising Federal deficits, and a very restrictive monetary policy. The sharp increases in long-term interest rates that resulted had widespread pervasive effects on the economy, including causing sharp declines in new housing, expenditures for consumer durables and capital goods, as well as causing a severe deterioration in the U.S. trade balance because of the highly overvalued dollar that resulted.

Stage 3 of the stagnation process occurred during much of 1982, when the major factor which continued to exert downward pressure on economic activity was the severe cost-cutting which took place at that time in most industries.

These cost-cutting measures included inventory liquidation, in which inventories were cut below previous historical levels; reductions in capital spending in order to conserve cash flow; increased layoffs and numerous wage freezes and reductions in order to reduce labor costs; reductions in travel budgets; and other such actions. These cost-cutting actions occurred in many companies for any of several different reasons: **(1)** In many cases, cost-cutting became necessary as a survival tactic. This has been especially true for those companies who have been most adversely affected by the acceleration of inflation and extremely high interest rates which ultimately led to this long period of economic stagnation. **(2)** Even in those cases where survival is not at stake, profit margins have been squeezed sharply in recent years—much of the streamlining has been implemented in order to stop the hemorrhaging of such margins and to start the rebuilding process. **(3)** The sharp decline in inflation in recent years has made it more difficult to pass on cost increases; thus, cost control has taken on increased significance. **(4)** With many markets having declined dramatically in recent years, more and more companies are attempting to increase share. Becoming a low-cost producer in many cases is the tactic being used to build market share. **(5)** The overvalued dollar has made it more difficult for numerous companies to compete effectively against imports and to maintain the size of their export markets. Many cost reduction measures were implemented as part of an overall effort to compete more effectively against foreign producers.

The long period of stagnation appears to have ended in the fourth quarter of 1982. Since that time, an improvement in economic activity has taken place, although as indicated below, it has been somewhat below the rate of recovery in previous post-recession periods. This is particularly true in view of how depressed the economy was when the recovery began.

IS THE RECOVERY SUSTAINABLE?

In my judgment, the recovery thus far has extremely strong underpinnings which not only suggests that it is not just a transitory improvement, but that it could be a start of a long period of sustained expansion, provided that higher interest rates are prevented. These underlying fundamentals are as follows:

1. Regardless of which measure is used, **the rate of inflation** has dropped sharply, and the outlook for inflation remains extremely promising for the next several years. The favorable outlook for inflation is the result of several forces: **(a)** A significant increase in oil prices is unlikely during the next several years as a result of the relatively sharp decline in oil demand caused primarily by fuel substitution and conservation. Efforts to increase production by Mexico and other countries experiencing financial difficulties could in fact actually produce some additional declines in oil prices. **(b)** The rate of increase in wages has dropped sharply. While some of this reflects the impact of rising unemployment and cost-cutting, a significant portion of it reflects the effect of foreign competition and the significant slowdown in cost-of-living adjustments in both union and nonunion wages, resulting from lower oil prices and reduced inflation in general. **(c)** The underlying trend growth in productivity is beginning to accelerate after several years of decline, reflecting the impact of more favorable demographics and other factors. In addition, productivity growth will be further enhanced by cyclical forces and by current efforts to improve efficiency. **(d)** Massive excess capacity in most industrial markets (on a worldwide basis) will remain for at least several years. **(e)** Large crop supplies will continue to hold down food prices—supplies for most other major commodities are also extremely favorable. **(f)** Even with some adjustment, Federal Reserve policies will not likely become excessively stimulative.

These forces will likely result in a rate of inflation of between 4 and 6 percent during the next several years. Further declines in the inflation rate will be preventd by continued rebuilding of profit margins; by modest increases in commodity costs due to low inventories; and because further wage concessions will not likely be granted as profits continue to improve during the economic recovery.

2. Both the **ability** and **willingness** of **consumers** to spend have improved dramatically, and further improvements are likely. This is illustrated by:

(a) Personal income in both nominal and real terms have been growing more rapidly in recent months. We expect real disposable income to grow at a more than 4 percent rate during the rest of this year, with the following factors contributing to the growth:

- As discussed above, inflation will remain modest, with CPI increases averaging in the range of 5 percent during the next year, well below the double-digit range of the 1970s.
- The third installment of the tax cut took place on July 1—this added $30 billion in purchasing power during the next 12 months. Although many state and local governments are raising taxes, these will offset only a small portion of the Federal tax cut.

- The bulk of the employment declines caused by inventory liquidation and cost-cutting now appears to be over—as discussed earlier, employment has actually begun to rise.
- The extension of unemployment benefits will prevent a loss in income for many workers who would have exhausted their eligibility during the months ahead.

b. The sharp increase in the stock and bond markets has added about three-quarters of a trillion dollars to household net wealth. While estimates of the impact of rising wealth on household spending vary, there nonetheless will be some effect.

c. The household debt burden remains relatively low. Furthermore, declines in interest rates on consumer installment loans are reducing the cost of carrying that debt somewhat.

d. Most measures of consumer confidence have improved dramatically in recent months, primarily because of a decline in the layoff rate, the increase in the stock market, and lower interest rates.

e. The pickup in housing will continue to stimulate consumer spending during the months ahead, particularly for durables. This is a normal pattern, reflecting the need to furnish new homes.

3. By virtually every measure, **fiscal thrust** is now larger than at any time since the late 1960s, as a result of large tax cuts and sharp increases in military expenditures. Furthermore, the peak period of budget cuts in the nonmilitary area is behind us, reducing the fiscal drag associated with these cutbacks.

4. **Total profits**, as well as those of nonfinancial corporations, actually edged up somewhat even before the recovery began, and are now rising more rapidly. In addition, **inventories** have been cut back more sharply during this recession than during any other recession in the postwar period and are relatively low in most industries. These forces have already combined to reduce the magnitude of cost-cutting and inventory-reducing actions relative to 1982.

5. Reflecting a major policy shift, short-term **interest rates** declined by about six percentage points during the second half of 1982—long-term rates declined almost four percentage points during the same period. In my judgment, the decline in rates was primarily the result of a shift in Federal Reserve policy away from the extremely restrictive policies of the last several years. This change, coupled with increased emphasis on reducing future budget deficits, partly reversed the forces which caused the sharp increase in interest rates during the first half of 1981.

Thus, the economic recovery has begun primarily because all of the forces which either initiated or extended economic stagnation between 1979 and 1982 have been at least partly reversed. The recovery process has been led not only by a shift away from massive inventory liquidation but by significant increases in housing and consumer spending in response to these factors. Nonetheless, as mentioned earlier, the recovery thus far has been somewhat below those in prior recovery periods; it has been erratic from month to month; and it remains uneven across industries and sectors of the economy.

In my view, even with the recent increase in interest rates, the recovery is almost certain to continue for the rest of this year and into 1984, primarily reflecting the likelihood of continued growth in consumer spending. Growing real incomes, rising consumer confidence, and the other factors discussed above will be reinforced by the fact that many families have cut their living standards in recent years and are anxious to restore them to previous levels,

generating a large pent-up demand for many goods and services—thus, the improvement in the ability to spend, as well as more confidence regarding job security, is bound to be reflected in higher expenditures during the months ahead. In my view, this virtually assures a continued recovery for the remainder of this year. Furthermore, these increases in consumer spending will have favorable multiplier effects by leading to higher capacity utilization in many industries and higher tax revenues for governments. Thus, some of the downward pressure on the economy resulting from cutbacks in government spending and weak investment will diminish, although great strength is not anticipated in these sectors during the months ahead. Finally, the recovery will be aided by significant increases in military expenditures during the months ahead, reflecting the large increase in defense orders during the last year.

WILL IT BE A BOOM?

The 6.6 percent increase in second-quarter GNP indicated by the "Flash Report," as well as recent data for industrial production, housing starts, and retail sales, are now leading to widespread forecasts of boom-like growth rates for the rest of this year and 1984. However, while it remains highly probable that the recovery will continue at least into 1984, extremely rapid growth is unlikely—the recovery will be relatively moderate, with the rate of growth declining somewhat relative to the second-quarter.

1. A substantial portion of recent increases in production reflect the absence of additional inventory liquidation, following the record rate of runoff experienced during the prior two quarters. In fact, this alone accounted for over one-half of the second quarter increase in GNP; the increase in final sales was only about 3.4 percent, which, while stronger than the 1.3 percent increase in the first quarter, is nonetheless relatively modest. In fact, the increase in real final sales during the recovery thus far is less than in any previous recovery (see **Table 1**). And, even with the inventory shift, the increase in both real GNP and industrial production during the past six months is less than in the first six months of most previous recoveries (see **Tables 2** and **3**). Furthermore, unless there is substantial inventory accumulation in the period ahead, the growth in production will slow down since the impact on GNP will be less than the $13 billion shift in the change in inventory accumulation experienced in the second quarter. However, a number of factors argue against a rapid inventory buildup in the period ahead. **(a)** Both nominal and real interest rates remain relatively high, implying high carrying costs. **(b)** The still low level of economic activity, despite recent improvements, has reduced the risks of major sales losses because of inadequate inventories, since orders can be filled relatively promptly. **(c)** Profit margins are still depressed, so most companies remain extremely cost conscious. **(d)** Material and commodity supplies are extremely plentiful. **(e)** The inflation psychology of recent years has been dampened, so that expected profits from holding inventory have been reduced dramatically. Recent declines in commodity prices have reinforced this.

2. While consumer spending will continue to rise in the months ahead, the increases in real terms will be somewhat smaller than in recent months. **(a)** The saving rate has dropped sharply in recent months. There are a number of factors that have probably contributed to this decline, including the sharp increase in the stock market which may be fueling some spending growth in excess of the increase in earnings; the improvements in consumer confidence; anticipatory spending prior to the July 1 tax cut; the fact that large tax refunds are being seasonally adjusted out of the NIPA data; and the still high level of unemployment which sharply reduces the saving rate of those people directly affected. Nonetheless, the low saving rate is somewhat puzzling in view of other factors which should push the saving rate higher. These include still high interest rates; the reductions in marginal tax rates which were designed to stimulate savings; and the dramatic shift in the distribution of income toward upper-income groups which traditionally have a higher rate of savings. Some rebound in the saving rate in the months ahead is highly likely, particularly to the extent that spending rose prior to the tax cut, suggesting a

somewhat slower rate of growth in spending. (b) The CPI has already begun to accelerate relative to the increases of late 1982 and early 1983, and further increases are likely during the rest of this year. The pickup in consumer prices will primarily reflect the fact that declines in oil, food, housing, and commodity prices, all of which contributed to price stability earlier, are now being reversed. Furthermore, after reaching record low levels during 1982, profit margins are expanding in response to rising demand. While the pickup in inflation is not a cause for alarm since inflation will still be low enough to permit continued economic recovery, it nonetheless implies somewhat smaller increases in real incomes for many households. (c) While the rising stock and bond markets will help fuel spending, the increases will be relatively modest because the gains are concentrated among upper-income people who have a relatively low marginal propensity to spend. Furthermore, the stock market appears to have peaked, and bond prices have dropped significantly in recent weeks—this will not only reverse some of the gains in wealth but prevent further improvements in confidence as well.

3. Despite the sharp increase in housing starts in May, the rebound in new housing construction is in the process of peaking. Thus, nonresidential construction will contribute far less to the recovery later this year and in 1984 than during the first half of this year. This is particularly important because the rebound in housing was the primary factor which fueled the recovery process earlier this year before consumer spending began to accelerate. Furthermore, increases in housing activity have a high multiplier impact because it affects numerous other industries. Starts will taper off somewhat later this year in both the single-family and multi-unit categories. In the former case, many first-time buyers who can afford current mortgage rates have already entered the market. These people traditionally buy existing homes but have entered the new housing market because they have been purchasing much smaller, less expensive homes that are currently available on the resale market (including mobile homes). However, with mortgage rates still relatively high and having edged up recently, many young first-time buyers are still effectively priced out of the market. Furthermore, high mortgage rates continue to discourage turnover of existing homes by preventing the normal upward migration process that has characterized the housing market historically. With respect to multifamily units, starts have risen dramatically in recent months, with much of the activity concentrated in the Southwest (especially Texas). However, vacancy rates appear to be rising rapidly in virtually all markets, as indicated by a sharp decline in absorption rates of newly completed units. Furthermore, some of the surge in Texas resulted from a plentiful supply of funds available to finance such construction. I believe that multifamily housing starts will drop during the remainder of this year.

4. Prospects for U.S. exports remain extremely poor, as illustrated by an additional decline in May. This reflects not only a highly overvalued dollar on a purchasing parity basis, but also continued sluggish economic activity in most export markets. The recession in Latin America is likely to continue for the balance of this year. Furthermore, economic activity remains very weak in most of Europe, with only Germany and the United Kingdom showing any signs of modest improvement and the Japanese economy is still growing very slowly, with domestic demand actually declining. Even if the dollar were to weaken later this year, the effects on trade shares would not occur until next year. And, as also evidenced by a rise in imports in May, the competitive advantage that many foreign producers have as a result of an overvalued dollar is causing significant increases in import penetration in the U.S. market, so that a larger than normal fraction of rising demand is being satisfied by overseas production.

5. Although the recent plant and equipment survey projects strong increases in investment during the balance of this year, current indicators suggest a more sluggish outlook. While expenditures for computers, telecommunications, and similar types of equipment will rise substantially, these increases will be greatly offset by declines in construction of office buildings and in most other types of nonresidential construction, as well as continued sluggishness in heavy-duty trucks, construction equipment, farm equipment, machine tools, and

other types of capacity-related business equipment. Thus, on balance, the recovery will not be aided by any significant improvements in overall capital spending during the next six to nine months. This expectation is reinforced by the fact that order rates and project starts remain below the current level of expenditures. In fact, unfilled orders for nondefense capital goods are still not improving despite some modest improvement in orders.

6. While the budget situation of state and local governments in the aggregate is beginning to improve, many municipal governments are still experiencing extremely tight budget conditions and continue to restrain expenditures. State and local government spending will pick up somewhat in the months ahead, reflecting funds allocated for highway improvement from the gasoline tax, but expenditures for other programs will continue to remain very weak. In addition, recent increases in tax rates at the state and local level are offsetting part of the Federal tax cut.

7. Reflecting widespread participation in the payment-in-kind program, farm production will fall during the remainder of this year. Furthermore, this will have adverse effects on many supplier industries, including agricultural chemicals, fertilizers, and farm equipment.

8. As discussed in previous months, significant additional declines in interest rates needed to strengthen the recovery are not likely; in fact, the risks of higher rates sometime in the next 18 months have actually increased. The Fed has already tightened a bit in recent weeks in response to extremely rapid growth in the basic month supply, since the growth in M1 can no longer be explained by the new money market accounts. It now appears that the Fed is targeting the Federal funds rate in the 9 to 9 1/2 percent range as compared with between 8-1/2 and 8-3/4 percent previously. Unless significant additional declines in the money supply occurs, this pattern is likely to continue—in fact, if M1 growth does not decline, some additional modest tightening could occur during August. While these small increases in interest rates are not likely to stall the recovery in view of the growth in consumer spending and recent increases in orders, they will nonetheless prevent a more vigorous rebound.

LONGER TERM OUTLOOK

The outlook for the economy beginning in early 1984 and beyond depends principally on interest rates. While most of the underlying forces discussed previously will remain in effect and can contribute to a continued recovery, they are likely to be offset by the impacts of higher interest rates if rates should rise back to the levels experienced in 1981. This is particularly true in the current environment because the economy is more sensitive to interest rates now than in previous periods. This primarily reflects (a) deregulation in financial markets, which causes larger changes in interest rates in response to changes in credit demand; (b) the expectation that financial markets will become increasingly concerned over the size of future deficits; (c) the floating exchange rate environment, which implies that higher interest rates will likely cause a further strengthening of the dollar and thus a weaker competitive position for U.S. companies in world markets. This will likely cause additional weakness in U.S. exports and further import penetration in many U.S. markets; and (d) consumer confidence in recent years has become more closely correlated with higher interest rates—consumers apparently view rising interest rates as a sign of bad times ahead and tend to retrench as a result.

In my view, preventing a strong rebound in interest rates and, in fact, encouraging even lower rates, will require the following policy actions: (1)It is essential that the Federal Reserve avoid a substantial tightening in monetary policy, despite the strong growth in the basic money supply in recent months. Such tightening should be avoided for the following reasons: (a) much of the growth in money reflects the impact of lower interest rates and lower inflation on the distribution of savings and deposits; (b) much of it reflects the growth in nontransaction

balances, reflecting financial market deregulation and the availability of new deposits; (c) as evidenced by recent declines in commodity prices and the rising dollar, inflationary expectations are not increasing despite the growth in the money supply; (d) Several months of excessive growth in money, even if that were the case once the distortions were eliminated, would not generate new inflationary pressures in view of declining velocity and substantial excess capacity in U.S. and world markets; (e) the still fragile international debt situation, and the continued overvalued dollar, also argue against any tightening of monetary policy which would push interest rates higher in the short term. If, in fact, the Fed were to sharply tighten in the months ahead, this could cause an end to the recovery process some time during 1984.

(2) While the short-term outlook for interest rates depends principally on Federal Reserve policy, the long-term outlook will be determined by the Federal deficit. In my view, unless significant actions are taken to reduce future deficits, interest rates are bound to rise very sharply in late 1984 and 1985, even with a relatively accommodative monetary policy—this would likely abort the recovery some time in 1985. Thus, it is essential that additional spending reductions and revenue increases aimed at 1984 and beyond be implemented as soon as possible. This is discussed further in the section below.

THE FEDERAL DEFICIT—MAJOR ISSUES

How Big Will Future Deficits Be?

The magnitude of future deficits can be seen in **Table 4**; these estimates are the most recent made by the Congressional Budget Office (CBO) and are based on their baseline, or most likely, economic forecast. As can be seen in the table, the Federal deficit will be above $200 billion through 1988. Projections beyond that point suggest that interest expense will be out of control and hence the total deficits will be even higher. Furthermore, these expected deficits as a share of GNP would be by far the highest in postwar history, especially relative to any other period during which the economy was growing.

Of most significance is that the deficits shown in Table 4 are based on the assumption of economic growth between 1983 and 1988 of about 4 percent per year on average—this can be seen in **Table 5**, which summarizes the CBO baseline forecast, as well as alternative forecasts. (The 2.1 percent growth rate predicted for 1983 on a year-over-year basis significantly understates growth expected during the year—about 4 percent—because of the low starting point at the end of 1982.) Moreover, an average annual 4 percent growth rate for six consecutive years is virtually unprecedented in postwar history—thus, the projection of rising future deficits, with current policies in effect, is not the result of pessimistic assumptions regarding economic performance.

This is illustrated further in **Table 6**, which shows alternative budget projections based upon the high and low growth alternative economic forecasts shown in Table 5—as can be seen, with lower economic growth (averaging only slightly more than 3 percent over the six-year period), the deficit would be $100 billion higher by 1988, at about $363 billion. Even with the faster growth scenario, which includes a more typical, sharp rebound from the 1981-82 recession than in the baseline projections, followed by average 4 percent growth thereafter, the deficit would still be nearly $200 billion in 1988, roughly in line with the deficit in the current year. Thus, even with extremely rapid growth, there would be no decline in the Federal deficit during the 1980s.

In essence, counting on a rosy economic outlook to reduce future deficits is a Catch-22 argument since such an outlook has already been assumed in deficit projections. Furthermore, large structural deficits will eventually cause high long-term interest rates, which, as discussed below, would prevent faster growth and could in fact cause another recession.

The economic magnitude of future deficits, and the fact that they do not result from inadequate economic growth, can be seen in other ways as well. As shown in Table 4, without any policy changes, the deficit on a full-employment basis (using 6 percent unemployment) will reach 4.3 percent by 1988, as compared with less than 1 percent in 1982. To put this in some historical perspective, the full-employment deficit as a percent of GNP has not exceeded 2 percent at any time in the postwar period except during 1967, when the war in Vietnam was being escalated at the same time that Great Society programs were being implemented.

Why Are The Deficits So Large?

The rising deficit trend reflects the fact that the combination of tax cuts and increases in military spending, many of which are yet to come, will far offset cuts in nondefense spending, many of which have already occurred. While it is true that the military buildup follows many years of declining real military expenditures, it comes on top of continued growth in most of the entitlement programs, as well as big increases in interest expense, so that overall Federal spending will continue to grow at a significant rate. At the same time, the revenue base has been eroded by the tax cuts in 1981. Quite clearly, the combination of large tax cuts and a massive military buildup cannot be afforded at the same time as long as this country's commitment to Social Security and a safety net to the poor remains fundamentally intact.

Federal expenditures as a share of GNP have continued to grow recently, despite the significant budget cuts adopted by the current Administration. The source of this growth is the sharp increases in defense spending already underway; very large increases in interest expense, reflecting high interest rates and a growing national debt; and the continued increases in Social Security benefits—the share of those three programs as a percent of total Federal expenditures has risen sharply. It is virtually impossible to implement cuts in other programs that come anywhere close to matching increases in those three areas. In fact, all other programs would have to be reduced to 8 percent of expected Federal revenues in 1985 in order to balance the budget. This is not only impossible, but illustrates that making significant inroads into Federal deficits cannot be done exclusively on the expenditure side as long as defense and Social Security remain virtually untouched.

While the recent recession has also pushed up Federal expenditures as a share of GNP, this ratio will remain relatively high in the years ahead without further expenditure reductions, even with the assumption of a relatively strong economic recovery. And, total Federal revenues as a share of GNP will continue to decline, reaching nearly 3 percentage points less than in 1980. The decline in Federal revenue as a share of GNP obviously reflects The Economic Recovery Tax Act of 1981, shown in **Table 7.** As can be seen, the reduction in tax revenue will ultimately reach $267 billion per year by 1988—most of that has still not occurred. Furthermore, as shown in **Table 8,** only about one-fifth of this has been offset by The Tax Equity and Fiscal Responsibility Act of 1982. Thus, the major impact of the net tax reductions on the Federal deficit is still ahead of us, as is most of the buildup in military expenditures, while, as mentioned earlier, many of the budget cuts have already occurred. This is the fundamental reason why the deficits will continue to rise, even with an economic recovery during the years ahead—the major budgetary impact of the Reagan Administration's economic program will come in the years ahead. This future deficit outlook, if it materializes , will for the first time in the entire postwar period, insure that the national debt as a share of GNP will rise sharply in the years ahead.

Can Anyone Really Predict Future Deficits?

Some have argued that it is virtually impossible to forecast deficits even one or two years ahead, let alone five years ahead, so that such projections should not be used as a basis for economic policy. There is no question that forecasts of Federal deficits have frequently contained large errors. However, historically, most of these errors have been in the direction of understating deficits. Furthermore, as shown earlier, future deficits will be extremely high, even under the most optimistic assumptions. Thus, those who argue that no actions should be taken to reduce future deficits because they cannot be predicted accurately seem to be on weak ground. Furthermore, there are some who argue that the deficit is only an accounting relationship and is thus meaningless. This is a peculiar argument since, while the deficits do reflect the difference between revenues and expenditures, they also are the major determinant of new Treasury borrowing in any given year.

The Likely Impact of Rising Deficits

In my judgment, the most likely effect of a pattern of rising deficits during an economic recovery will be upward pressure on interest rates. This primarily reflects the fact that private credit demands always rise during recovery periods. In fact, private credit demands actually rise more rapidly than nominal GNP during periods of economic growth, reflecting strong demand for consumer durables, capital goods, and inventories, all of which are heavily financed by borrowing—and, it is virtually impossible to sustain a recovery period without strong growth in these areas. Thus, the major concern regarding rising deficits is that they will collide with increases in private credit demands and cause upward pressure on interest rates (if the Fed does not fully accommodate them) or, eventually, they will cause upward pressure on interest rates from a sharp acceleration of inflation (if in fact they are financed by continued rapid growth in the money supply). There is some evidence to suggest that anticipation of either of these outcomes is already keeping long-term interest rates considerably higher than they would otherwise be.

Have Interest Rates Not Declined Despite Rising Deficits?

There are many who claim that the link between interest rates and deficits is very weak and that, in fact, interest rates frequently decline when deficits rise. This pattern did indeed occur during 1982. However, this correlation reflects the historical pattern of rising deficits during recessions, when private credit demands have been extremely weak—it is easy to accommodate high and rising deficits during such periods. The problem in the period ahead will be that the deficits will rise at the same time as private demands increase. Such a pattern is unprecedented, so that the weak historical correlation between interest rates and budget deficits is fundamentally irrelevant. Furthermore, the decline in interest rates which occurred in 1982 took place primarily because the Federal Reserve eased dramatically during the second half of the year, plus the fact that the Congress passed legislation designed to reduce future deficits. While the deficit experienced in 1982 was considerably higher than previously expected, this reflected the depth of the recession—thus, the larger deficit in 1982, and projections of even higher deficits in the years ahead because of the depth of the 1982 recession, did not affect interest rates because they do not reflect any change in the underlying pattern of structural deficits. Furthermore, the decline in long-term interest rates was far less than those on shorter-term maturities, and they currently remain well above short-term rates. And, despite last year's decline in nominal rates, interest rates in real terms still remain extremely high. This suggests that the deficit outlook is already keeping interest rates higher than they would otherwise be.

Effects of High Deficits On The Economy

The basic problem is that, while that portion of the deficits reflecting the weak state of the economy must be maintained, and stimulus from modest additional deficit spending is desirable, deficits that become bigger and bigger are not necessarily more and more stimulative. This is especially true in the current economic environment because deregulation of financial markets and the more monetarist approach to Federal Reserve policy will cause sharper increases in interest rates in response to rising credit demands than in previous years. Furthermore, the sensitivity of economic activity to interest rates has increased over time, reflecting the floating exchange rate environment, the increased swing in the prices of many financial assets and housing, and the closer correlation between consumer confidence and spending to interest rates.

Thus, excessive deficits will be at least partially self-defeating because the resulting rise in interest rates will cause sharp declines in several sectors of the economy:

1. Mortgage rates are the major factor affecting the housing industry—a sharp decline in housing would likely occur again if rates rose sharply.

2. Higher interest rates would directly reduce consumer spending for credit-sensitive durables, as well as causing additional retrenchments in household spending because of weak confidence, declining values of financial assets, and the adverse effect of weaker housing activity.

3. Higher interest rates would likely cause a new round of cutbacks in public works projects and other spending by many municipal governments.

4. A new period of rising interest rates would likely exert new upward pressure on the U.S. dollar on foreign exchange markets, causing additional declines in U.S. exports and increased foreign penetration in U.S. markets.

5. Both the direct effect of higher interest rates, and the indirect effects through lower capacity utilization, weaker profits, etc., would cause additional cutbacks in capital spending.

Thus, high and rising interest rates would have widespread, adverse effects on U.S. economic performance—this lesson was learned in 1981 and 1982. Moreover, a rebound in interest rates would prevent the sustained recovery necessary to reduce unemployment and help correct other economic problems in the United States. Furthermore, a growing U.S. economy is needed to ignite a worldwide economic recovery, to alleviate the external debt problem of many lesser-developed countries, to stem the tide of increased protectionism, and, eventually, to reduce the strains on the international financial system.

Will Tax Increases Cause A Depression As They Did in the 1930s?

In my view, it is clear that an adequate solution to the deficit problem will require revenue increases above those now anticipated, either by the implementation of tax increases or a delay or cancelling of some or all currently scheduled tax cuts such as "indexing". Will this abort the recovery, or worse, cause a depression?

No, because the portion of the deficits that will be reduced is not caused directly by weakness in the economy, unlike the 1930s. Significant deficit-reducing actions can be taken merely by reducing currently legislated tax reductions; actual tax increases would be neither

necessary nor desirable. Declining structural deficits of the magnitude suggested above would still leave ample stimulus to bolster the recovery process, and would make room for the increase in private credit demands that would result. Furthermore, deficit-reducing actions would not become effective until the economy is further into its recovery process.

Will There Be Any Tax Cut Left?

As illustrated earlier, it is virtually impossible to reduce future deficits on the spending side alone, unless more drastic actions are taken regarding Social Security expenditures than contained in the recent Social Security bail-out program (which is unlikely) or unless the military buildup is scrubbed (which is also unlikely). Thus, tax actions will be necessary.

It is certainly true that a significant portion of the 1981 reduction in personal tax rates is already being offset by inflation and increases in excise, Social Security, and state and local government taxes. But a significant net tax reduction will remain, even with the additional actions that will be necessary to reduce future deficits, particularly since lower-than-expected inflation has sharply reduced the magnitude of "bracket creep." Furthermore, the key issue is not how large the tax cut is going to be, but how much we can afford in view of the fact that overall Federal expenditures will not be declining significantly.

Other Considerations

There have been other arguments made to suggest that actions to reduce deficits are unnecessary:

1. Deficits in Germany and Japan are higher than those in the United States. Those who argue that it is unnecessary to reduce our deficits because they are higher in Germany and Japan are ignoring the fact that savings rates in those two countries are three times higher than they are in the United States. Deficits can be more easily financed in those countries than they can be here. The fact is that, in the United States, deficits of the magnitude currently anticipated without new actions would absorb most of our savings in the years ahead, and would represent such a large fraction of newly available credit that little or no credit would be available to finance new investment or other private sector activities. Resulting higher interest rates would not only directly weaken overall economic activity but would also reduce long-term growth by squeezing out investment. Growing investment is necessary both to increase available capacity in order to support economic growth, as well as to increase productivity in order to keep long-term inflation down. High and rising deficits that soak up a growing share of credit and savings will discourage investment and thus significantly retard the long-term outlook for inflation and economic growth in the United States.

2. The deficits can be financed overseas. While it is true that increased funds from overseas can help finance the deficits, they would not be sufficient unless the dollar strengthens even further. Net foreign investment in the United States is relatively small compared to the size of the U.S. deficit. The high interest rates that would be necessary to cause an increased influx of foreign funds would, by overvaluing the U.S. dollar even more, cripple our competitiveness in world markets and further devastate the industrial sector in the United States. This is not an appropriate solution to the deficit problem.

3. Cuts in marginal tax rates, and other features of the economic program, will increase savings substantially. While it is true that some increases in savings will result from recent tax cuts, the empirical evidence shows that this will not be sufficient. Furthermore, any increases in savings that are used to finance the deficit cannot be used to finance investment or other expenditures. Thus, higher savings would not necessarily improve long-term growth prospects.

4. Deficits do not matter; only government spending does. While it is true that a given-size deficit at higher levels of Federal expenditures and taxes is less preferable than the same deficit at lower expenditure and revenue levels, this argument does not address the issue of Treasury borrowing and its effect on financial markets and interest rates. Higher levels of spending and taxes might in the long run mean a less efficient and a less productive economy than lower levels do. But large Treasury borrowing can still cause upward pressure on interest rates.

Recommendations

Incurring the risks associated with rising deficits during a recovery period seems unwarranted in view of the weak level of investment, and the widespread financial strains that characterize the economy, all of which will likely worsen if the Federal Government continues to absorb most newly available credit and savings. Furthermore, while some longer-term factors are contributing to the problems of the industrial sector, current problems are primarily the result of the high interest rate/recessionary environment of recent years. Unless these conditions are reversed in the near future, many manufacturing and mining companies may never recover.

The top objective for economic policy should be a sustained period of strong economic growth. This can only be accomplished if policy is geared toward lower interest rates. This will require not only continuation of a more accommodative policy by the Federal Reserve, but also a more balanced approach to fiscal policy that significantly alters the outlook for the Federal deficit. The risks of an unprecedented pattern of rising deficits during a recovery are so large that additional measures should be adopted in order that projected future deficits decrease by at least $25 billion per year, beginning in fiscal 1985. Reducing future deficits to these levels will require significant spending cuts in all areas. In addition, currently scheduled tax cuts will have to be scaled back, or offsetting tax increases enacted, by amounts exceeding the contingency tax increase suggested by the President, and with an earlier effective date.

FORECAST SUMMARY

The standard forecast, which is based on the assumption that some additional deficit-reducing actions will be implemented and that the Federal Reserve will remain accommodative and not tighten significantly, is summarized in **Table 9.** The highlights are as follows:

Real GNP will rise by 7.2 percent in 1983.2, after growing by 2.6 percent in 1983.1. Real output is expected to rise by 2.8 and 4.6 percent in 1983 and 1984, respectively.

Consumer Spending will rise this year in response to net tax cuts and lower inflation. Real outlays will rise by 3.6 percent in 1983 and 4.2 percent in 1984.

Auto Sales will improve somewhat in response to lower interest rates, rising real incomes and modest price increases. Sales will average 9.1 and 10.3 million units in 1983 and 1984.

Investment Spending will remain sluggish as a result of low operating rates and recent sharp declines in corporate profits. Fixed business investment will decline by 2.9 percent in 1983, before expanding by 2.4 percent in 1984.

Housing Starts will improve in response to recent declines in mortgage rates and will averag about 1.61 and 1.67 million in 1983 and 1984.

Industrial Production. Total output will increase by 4.6 and 7.8 percent in 1983 and 1984.

Unemployment will continue to decline, albeit slowly, averaging 10.1 and 9.1 percent in 1983 and 1984.

Consumer Price Inflation will average 3.2 and 4.9 percent in 1983 and 1984.

Underlying the standard forecast are the following assumptions:

Taxes. Federal receipts reflect the repeal of withholding on interest and dividend income and full implementation of the personal tax cut scheduled for July 1983. Relative to current law, tax increases of $7 billion and $20 billion have been assumed in 1984 and 1985 respectively.

Government Spending. Federal expenditures (NIPA basis) will equal $818 billion and $884 billion in fiscal years 1983 and 1984. Federal government defense expenditures are assumed to grow 5 percent per year in real terms for 1984 and 1985. Nondefense spending is expected to grow slightly more rapidly than would be expected based upon current law as a result of some minor increases in grants-in-aid, transfer payment programs, and purchases of nondefense services. The total increase, relative to current law, is expected to be approximately $6 billion in FY 1984 and $10 billion in FY 1985.

Money Supply Growth (M1) will average 11.3 and 6.8 percent during the next two years.

Interest Rates will rebound slightly during the second half of this year before declining slightly next year. The rate on 90-day Treasury bills will average 8.5 percent and 8.1 percent in 1983 and 1984, respectively.

Oil Prices will fall by 11.0 percent in 1983 and rise by 0.5 percent in 1984.

Food Prices will rise by 3.0 percent in 1983 and 5.8 percent in 1984.

International Economic Activity will improve moderately during the forecast period in response to increased stimulative measures and stronger exports. The dollar will decline slowly relative to most currencies.

As mentioned earlier, however, a significant tightening by the Federal Reserve during the next several months could cause the recovery to slow even further in 1984 or stop completely, depending on the magnitude of the increase in interest rates. In 1985, the major risk is that interest rates can rise sharply because of rising Treasury borrowing, which would abort the recovery at that time.

Table 1
Real Final Sales
Cumulative Growth Rate
In the First Two Quarters of Economic Recovery

Recession	Growth Rate (%)
1948.4 - 1949.4	4.1
1953.2 - 1954.2	2.4
1957.3 - 1958.2	3.1
1960.2 - 1961.1	1.5
1969.4 - 1970.4	2.1
1973.4 - 1975.1	2.2
1980.1 - 1980.2	1.7
1981.2 - 1982.4	1.2

Table 2
Real Gross National Product
Cumulative Growth Rate
In the First Two Quarters of Economic Recovery

Recession	Growth Rate (%)
1948.4 - 1949.4	7.2
1953.2 - 1954.2	3.3
1957.3 - 1958.2	4.9
1960.2 - 1961.1	3.0
1969.4 - 1970.4	3.0
1973.4 - 1975.1	3.5
1980.1 - 1980.2	1.5
1981.2 - 1982.4	2.4

Table 3
Index of Industrial Production
Cumulative Growth Rate
In the First Six Months of Economic Recovery

Recession	Growth Rate (%)
11/48 - 10/49	13.9
7/53 - 5/54	3.1
8/57 - 4/58	9.5
4/60 - 2/61	7.9
12/69 - 11/70	4.1
11/73 - 3/75	9.3
1/80 - 7/80	7.9
7/81 - 12/82	6.5

Table 4
The Budget Outlook
Fiscal Years 1983-88

	Actual 1982	Est. 1983	1984	Projections 1985	1986	1987	1988
			In Billions of Dollars				
Unified Budget Deficit	111	194	197	214	231	250	267
Revenues	618	606	653	715	768	822	878
Outlays	728	800	850	929	999	1072	1145
Off-Budget Deficit	17	17	15 16	19	17	17	
Total Federal Deficit*	128	210	212	231	250	267	284
Standard-Employment Deficit**	23	69	91128	159	187	215	
Publicly Held Debt	929	1128	1340	1571	1820	2087	2372
			As a Percent of GNP				
Unified Budget Deficit	3.6	6.1	5.6	5.6	5.6	5.6	5.6
Revenues	20.4	19.0	18.7	18.7	18.5	18.4	19.3
Outlays	24.0	25.0	24.3	24.3	24.1	24.0	23.9
Standard-Employment Deficit (Percentage of Standardized GNP)**	0.7	1.9	2.4	3.1	3.6	4.0	4.3

* Defined as the sum of the unified budget and off-budget deficits.

** Unified budget basis, calculated at 6 percent unemployment, with 2.6 percent average growth in the corresponding level of GNP during the 1983-88 period.

Source: Congressional Budget Office

Table 5
CBO Baseline and Alternative Economic Assumptions
(calendar year)

	1983	1984	1985	1986	1987	1988
Gross National Product (GNP)						
Current dollars (% change, year to year)						
High growth alternative	9.0	11.3	9.5	9.1	8.9	8.1
CBO baseline projection	6.8	9.6	9.0	8.1	7.6	7.4
Low growth alternative	5.4	7.9	7.9	7.2	6.6	6.4
Constant (1972) dollars (% change, year to year)						
High growth alternative	4.0	6.0	4.2	4.0	4.0	4.0
CBO baseline projection	2.1	4.7	4.1	3.7	3.5	3.5
Low growth alternative	0.8	3.3	3.3	3.2	3.0	3.0
Prices						
GNP deflator (% change, year to year)						
High growth alternative	4.8	4.9	5.1	4.9	4.8	4.9
CBO baseline projection	4.6	4.7	4.7	4.3	3.9	3.8
Low growth alternative	4.5	4.4	4.4	3.9	3.5	3.2
Consumer Price Index (% change, year to year)						
High growth alternative	4.6	5.3	5.0	4.6	4.6	4.8
CBO baseline projection	4.5	5.0	4.6	4.1	3.9	3.7
Low growth alternative	4.5	4.9	4.4	3.8	3.4	3.2
Unemployment Rate (percent, annual average)						
High growth alternative	9.9	8.5	7.7	7.0	6.4	6.0
CBO baseline projection	10.6	9.8	9.0	8.4	8.0	7.5
Low growth alternative	11.2	10.9	10.3	9.8	9.4	9.0
Interest Rate (91-day Treasury bills, percent, annual avg.)						
High growth alternative	4.4	5.4	5.7	5.0	5.0	4.9
CBO baseline projection	6.8	7.4	7.2	6.6	6.1	5.9
Low growth alternative	8.4	9.9	8.9	7.7	7.2	6.3

Source: Congressional Budget Office

Table 6
Baseline Budget Projections Under Alternative Economic Assumptions
(by fiscal year, in billions of dollars)

	1983	1984	1985	1986	1987	1988
Baseline Revenues						
High growth alternative	615	676	742	798	862	933
CBO baseline projection	606	653	715	768	822	878
Low growth alternative	599	636	686	730	777	825
Baseline Outlays						
High growth alternative	793	830	904	971	1,041	1,116
CBO baseline projection	800	850	929	999	1,072	1,145
Low growth alternative	804	868	958	1,032	1,110	1,187
Baseline Unified Budget Deficit						
High growth alternative	178	155	162	172	179	183
CBO baseline projection	194	197	214	231	250	267
Low growth alternative	205	232	272	302	333	363

Source: Congressional Budget Office

Table 7
Revenue Effects of The Economic Recovery Tax Act of 1981
(by fiscal year)

	1982 Actual	1983 Base	Projections 1984	1985	1986	1987	1988
			In Billions of Dollars				
Individual Income Taxes	-29	-68	-105	-126	-155	-182	-213
Corporate Income Taxes	-9	-17	-26	-34	-42	-45	-43
Social Insurance Taxes	*	*	* *	*	*	*	
Excise Taxes							
Windfall profit taxes	-1	-1	-1 -1	-1	-1	-1	
Other	—	1	1 *	—	—	—	
Estate and Gift Taxes	*	-2	-4 -5	-6	-8	-10	
Total	-38	-88	-135	-167	-205	-236	-267
			As a Percentage of GNP				
Individual Income Taxes	-1.0	-2.1	-3.0	-3.3	-3.7	-4.1	-4.5
Corporate Income Taxes	-0.3	-0.5	-0.7	-0.9	-1.0	-1.0	-0.9
Other	**	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2
Total	-1.3	-2.6	-3.9	-4.4	-5.0	-5.3	-5.6

* Less than $500 million.

** Less than 0.05 percent.

Source: Congressional Budget Office

Table 8
Revenue Effects of the Tax Equity and Fiscal Responsibility Act of 1982
(by fiscal year)

	1982	1983 Base	Projections 1984	1985	1986	1987	1988
			Billions of Dollars				
Individual Income Taxes	—	5	13 12	15	18	20	
Corporate Income Taxes	—	7	16 19	26	32	31	
Social Insurance Taxes	—	2	3 4	3	3	2	
Excise Taxes							
Windfall profit taxes	—	*	* *	*	*	*	
Other	—	4	5 6	2	2	2	
Estate and Gift Taxes	—	—	* *	*	*	*	
Total	—	18	38 42	47	54	56	
			As a Percentage of GNP				
Individual Income Taxes	—	0.2	0.4	0.3	0.4	0.4	0.4
Corporate Income Taxes	—	0.2	0.5	0.5	0.6	0.7	0.6
Other	—	0.2	0.2	0.3	0.1	0.1	0.1
Total	—	0.6	1.1	1.1	1.1	1.2	1.2

*Less than $500 million.

Source: Congressional Budget Office

Table 9
Forecast Summary
Major Economic Indicators
(percent change)

	1980	1981	1982	1983	1984
Gross National Product	8.9	11.6	4.1	7.7	9.8
GNP in 1972 Dollars	-0.4	1.9	-1.7	2.8	4.6
Total Consumption, 1972 Dollars	0.3	1.8	1.0	3.6	4.2
Fixed Nonresidential Investment, 1972 Dollars	-2.2	3.5	-3.6	-2.9	2.4
Government Purchases, 1972 Dollars	2.2	0.9	1.5	1.0	2.7
GNP Deflator	9.3	9.4	5.9	4.7	5.0
Consumer Price Index	13.5	10.3	6.2	3.2	4.9
Corporate Profits Before Taxes	-4.0	-4.3	-24.6	20.5	18.9
Corporate Profits After Taxes	-4.4	-4.4	-22.4	15.2	14.6
Unemployment Rate, Civilian (%)	7.2	7.6	9.7	10.1	9.1
Prime Commercial Bank Rate (%)	15.3	18.9	14.9	10.8	10.3

Senator JEPSEN. If I may, I am going to have to go to vote. I would like to ask a response from both of you to this question, if you so desire.

But Mr. Chimerine, you're just elaborated at some length on the Federal deficits. I was somewhat surprised to hear you say that there is no decline in the Federal deficit probably during the 1980's.

Now how do you square that with the projection in the President's 1984 budget message showing that a real gross national product growth of just 1.33 percentage points faster than the forecast between now and 1988 will balance the budget by 1988?

Granted that the figure used, I believe, in the President's budget was 4.4—4 percent was the figure used. And if we went to 5.33, then the budget would be balanced. Now we are lumbering along at 8.7, and I understand that probably is not going to keep that red hot pace.

But even with some considerable drop, we are going to be, hopefully, above the 4 percent.

So, would you mind elaborating? I do not understand why you make your remarks, or if you can tell me why you make your remarks and it seems to make sense, and I do not understand why the President made those remarks.

Mr. CHIMERINE. Mr. Chairman, I think there are two factors to consider in response to that question. First, I agree—the best way to reduce future deficits is by faster economic growth. I don't think that is possible and, in fact, I think that the presence of those large deficits and the high interest rates that are in effect already, and potentially, even higher rates, will prevent that kind of economic growth. I do not see how we can get those kinds of growth rates on a sustainable basis over a period of many, many years, given the fact that the structural deficits are as high as they are and given the potential for a continuation of high, and even higher, interest rates.

In fact, the deficit calculations that the administration made in their base forecast assumed consistent 4 percent growth. That is a relatively good growth rate over a period as long as 4 years. I do not think it would be responsible to assume a faster growth rate than that in making deficit calculations.

Second, the administration's budget assumed a large number of budget reductions in the nondefense area which, in my judgment, are not likely to occur. They are certainly not occurring. They also assumed interest rates lower than what we are now experiencing, which will put upward pressure on the interest component of the Federal budget. They assumed much lower farm program expense and so on. They also included some contingency tax changes, repeal of interest and withholding and a number of other tax measures that are not now being enacted.

So the combination of economic growth, which will not reach those very rapid rates, and second, inaction on a whole range of items that are designed to reduce those deficits, I think makes the deficit outlook considerably worse than those numbers would suggest.

Senator JEPSEN. Would you care to respond to that, Mr. Rahn?

Mr. RAHN. Well, I disagree. First, I am a bit more optimistic than Mr. Chimerine is in our economic forecast. We had predicted a calendar year economic growth rate of 3.2 percent since January. At that

point, the consensus of private forecasters as shown by the blue chip indicators was 2.5 percent. OMB was at 1.4 percent at that point.

Now the consensus is up to 3.1 percent and I am sure after today's numbers, people will get up to where we are, or a bit higher.

If you take a look at the recent recoveries in the last 15 years, you find that when we had economic growth of 2 percent or more per year, that OMB and CBO underestimated the size of the budget deficit, ranging from 13 to 84 percent. And I think, clearly, with the higher rates of economic growth that we are going to have, and given the normal overestimation of the budget, that the budget is going to come down. We do have a budget problem and I do not want to overly minimize that.

But, clearly, in real terms, we will have a substantial decline in the budget. I can see a budget deficit as low as $140 billion in fiscal 1984 and even lower in fiscal 1985, without any major tax increases.

Senator JEPSEN. Thank you. I have a vote I must run to make. I would suggest that Mr. Rahn present his statement.

Representative LUNGREN [presiding]. Mr. Rahn, please present your testimony.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY RONALD UTT, DEPUTY CHIEF ECONOMIST, AND GRACE ORTIZ, DIRECTOR, FORECAST CENTER

Mr. RAHN. I sort of got into this backward here, but I will hop around some. Given that there are a few of us, I guess we will do it informally.

My name is Richard W. Rahn. I am vice president and chief economist of the Chamber of Commerce of the United States. And with me today is Ronald Utt, who is deputy chief economist of the U.S. Chamber, and Grace Ortiz, who is director of the Chamber's forecast center.

As I pointed out, the Chamber has been and continues to be optimistic about the near-term outlook for the economy. Today's numbers more than confirm our optimism. In fact, what we expect this year is for real economic growth to be about 6 percent. In 1984, we expect a slight dropoff to the 5.8-percent range.

The CPI, the Consumer Price Index, which rose roughly 3.7 percent this year, is likely to increase somewhat next year to roughly 4.9 percent. Unemployment rates will continue to fall. We're estimating an average rate of 9.7 percent this year and roughly 8.1 percent next year.

As I mentioned, I expect deficits to come down substantially in real terms and even somewhat in nominal terms. The reasons for our projections are laid out in detail in my prepared statement, which I understand from the chairman will be made part of the record.

We are concerned about a number of public policy risks, however. Our first concern is the growth in Federal spending. In 1980, the growth in Federal spending in real terms and by "real terms" I mean after inflation, was 6.5 percent. In 1981 and 1982, the Congress and the administration made some progress in bringing that growth down 3.4 percent. But then it still exceeded private sector economic growth.

This year, real Federal spending will go up by about 5.2 percent. When the President came in, it was his goal to bring down Federal spending as a percentage of GNP from the then 23 percent down to 19 percent by 1984. Instead, Federal spending has risen as a percentage of GNP and will be up to about 25 percent this year.

There have been opportunities to control Federal spending and there continue to be. But if you look at the breakdown of Federal spending, you see the programs that are most out of control are income security and the medical programs. And, clearly, we have to make some changes in the CPI indexing formulas that we use for many of the transfer payment programs.

We at the Chamber had recommended that you use 60 percent of the Consumer Price Index, which is roughly equivalent to the private sector COLA's.

We think any tax increase this year or next would be most ill advised. Last year, as you may recall, I had recommended against TEFRA and the Chamber's policy had been not to support TEFRA—that's the tax act this past summer. We argued that it would delay the recovery, which it did. We argued that the deficit would go up rather than down as a result of this act, and, of course, the deficit roughly doubled after the passage of TEFRA.

We see a particular danger in tax increases because the Congress, despite much rhetoric to the contrary, tends to go ahead and increase taxes on saving and productive investment. And that is the worst of all possible worlds, because if you increase taxes on saving and investment, you not only diminish the incentives for saving and investment, but by reducing the size of the saving and investment pool, even if you did reduce the nominal deficit somewhat, you do nothing to reduce crowding out.

We are also concerned about some of the growing trends that we see in the Congress for protectionism. Roughly 11 percent of our GNP now goes into exports. If we engage in protectionist measures, clearly they will be retaliated against and not only we, but the entire world, will be worse off. They are self-defeating and we encourage the Congress to try to avoid such protectionist measures.

Finally, and perhaps most importantly, we have been greatly concerned about monetary policy as has been managed by the Federal Reserve.

Last year, M_1 grew at an 8.5-percent annual rate, which was extraordinarily high. This year, in fact, as of June 8, we hit a historic date that day because on June 8 of 1983, the Fed managed to exceed their M_1 target for the entire year. Their target had been a range of 4 to 8 percent. Now they have a new target, as was announced yesterday, of 5 to 9 percent for the remainder of the year, which will give us a total year growth of M_1 of around 12 percent.

Now, I realize that they are arguing that this will be noninflationary. But it seems to me that they are trying to deny economic history. We have never had a period of time in our country where we have had this type of—not this type, but anywhere near this kind of growth in M_1 that was not followed from 6 to 24 months later by a very large surge in inflation.

We realize that the Fed has an enormously difficult task. Clearly, the people are men and women of goodwill who are trying to do their best. But we think that they have erred too much on the side of rapid monetary growth, and that is where the great risk is. We have noticed that the rise in interest rates has corresponded almost precisely with big growth in the money supply. And during those periods where the money supply was clearly going far faster than Fed targets, interest rates were going up. And those weeks or periods when it was going within or slower than Fed targets, interests rates were going down.

We hope you all would encourage the Fed to be much more restrained because I think, in our view, clearly, if this kind of policy continues, we are going to suffer the consequences of inflation sometime probably within the next 18 months.

That is a quick summary of my remarks and I would be happy to respond to any questions from the committee.

[The prepared statement of Mr. Rahn follows:]

Prepared Statement of Richard W. Rahn

Mr. Chairman, my name is Richard W. Rahn, Vice President and Chief Economist of the Chamber of Commerce of the United States. We appreciate the opportunity to share with you our bullish outlook on the U.S, economy and to discuss a number of public policy risk that may threaten the strength and longevity of the current economic expansion.

SUMMARY

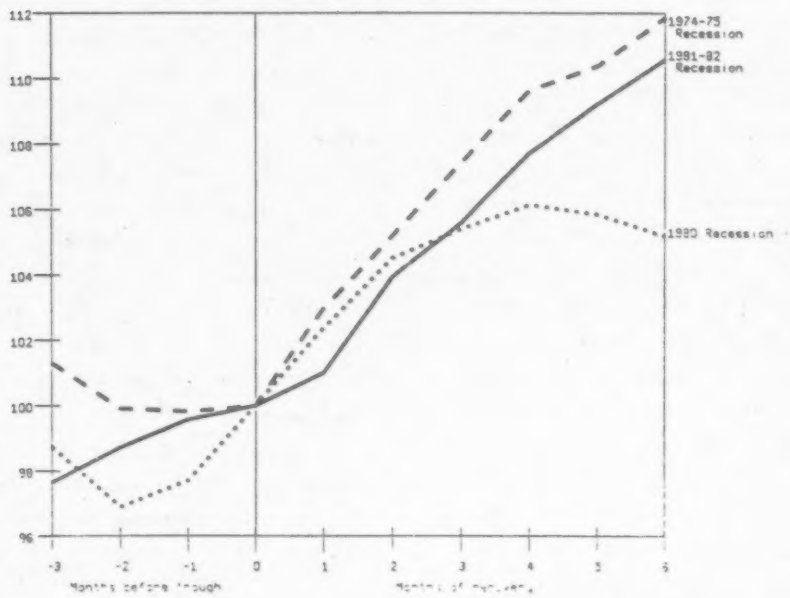
The U.S. Chamber of Commerce has been and continues to be very optimistic about the near term outlook for the recovery now under way. As we considered the state of the economy late last year, it was apparent to us that a robust recovery was about to emerge and that economic growth in 1983 would be well above the predictions of other leading forecasters in the private and public sectors. Indeed, in January, when we predicted a 3.2 percent rise in real GNP for calendar year 1983, the consensus of economic forecasters, as compiled in the Blue Chip Economic Indicators, projected only a 2.5 percent improvement in real economic activity. By and large, most forecasters predicted a weak recovery relative to past experience. It is, therefore, gratifying to see, seven months later, that the consensus forecast is now almost identical to ours. Whereas we continue to project a 3.2 percent increase in real economic activity, with high quarterly growth rates for the remainder of the year, the consensus forecast has been adjusted upward every month since January, and now projects a 3.1 percent rate of growth for the year as a whole.

At present, it appears that the pace of recovery may be stronger than even these revised forecasts project. The "flash" estimate of second quarter real GNP growth was reported at 6.6 percent, but many economists expect the actual rate of growth to be well above this. Moreover, the index of leading indicators continues to trace a growth path quite similar to the experience of the 1975 recovery (see chart 1), which by most measures was a strong upturn.

Chart 1

The leading index continues on the recovery track

(The index of leading indicators, recession trough=100)



While we continue to be optimistic about the strength of the current recovery, we are, nonetheless, concerned about the potential adverse affect that inappropriate monetary and fiscal policies may have on the recovery's strength and longevity. Pervasive fiscal imbalance, caused largely by a failure to stem the growth in federal spending, is leading to massive annual

tax increases that will diminish the strength of the recovery. An overly stimulative monetary policy will contribute to higher inflation, higher interest rates, and a growing likelihood that the Fed may have to severely restrict money and credit in an effort to return monetary growth to within a range consistent with stable prices and sustained economic growth.

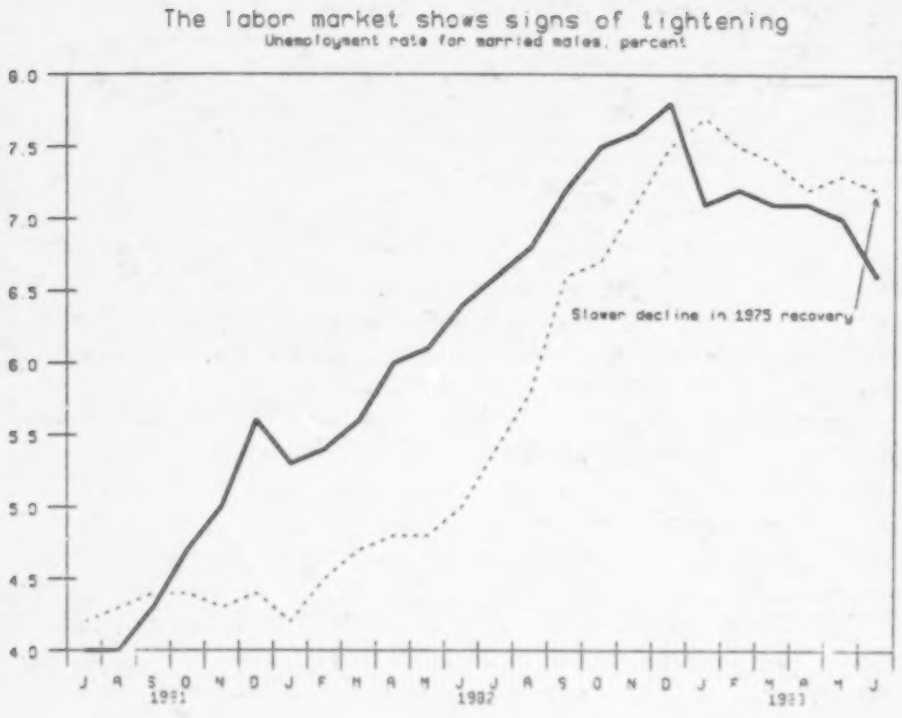
DETAILS OF CHAMBER FORECAST

The U.S. Chamber's current economic outlook calls for continued strong quarterly growth rates in real GNP averaging 5.7 percent on a fourth quarter-to-fourth quarter basis during 1983. Barring adverse monetary and/or fiscal policy developments, the recovery should continue at a strong pace during 1984 and 1985. The leading sectors, residential and inventory investment, which provided the initial thrust to the turnaround, have now been joined by rising consumer spending, including improved automobile sales, to sustain economic activity for the remainder of 1983. A mixed recovery in business fixed investment has also begun, and should surge in 1984 as the process of balance sheet reliquification is completed and capital outlays increase.

Consumer prices are expected to rise by only 3.4 percent this year, a dramatic improvement compared to recent levels of inflation. However, the fortuitous price developments which contributed to this impressive performance are unlikely to be repeated in 1984 and 1985. Further, the cumulative impact of soaring rates of growth in the money supply during the past several months, should begin to be reflected in an upturn in inflationary pressures during 1984 and 1985. Nevertheless, the projected increase in the consumer price index during the next two years remains low relative to recent experience, under the assumption that the Fed returns to a policy of moderate and stable monetary growth.

The employment situation has already brightened considerably. The unemployment rate for married males, a key indicator of labor market activity, has declined markedly since January, falling more rapidly than during the 1975 recovery (see chart 2). The overall unemployment rate is forecasted to fall to 9.2 percent of the labor force by the end of the year, and average 8.4 percent in 1984 and 7.5 percent in 1985.

Chart 2



Charts 3 through 6 show real GNP and its components during the past two years, and our forecast for 1983, 1984, and 1985. Residential investment and consumer spending will lead the recovery in the near term. Nonresidential investment will sustain economic activity in 1984 and 1985, while exports will continue to exert a drag on the economy throughout the forecast period.

Chart 3
REAL GNP AND CONSUMPTION
RECENT EXPERIENCE AND FORECAST
(INDEX, 1981:1=100)

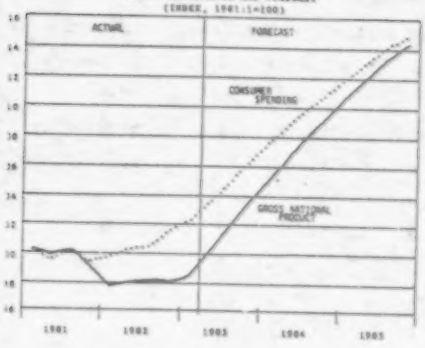


Chart 4
REAL GNP AND RESIDENTIAL INVESTMENT
RECENT EXPERIENCE AND FORECAST
(INDEX, 1981:1=100)

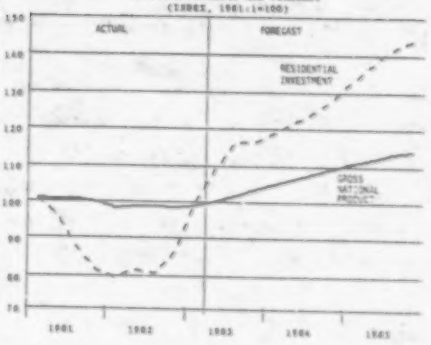


Chart 5
REAL GNP AND NONRESIDENTIAL INVESTMENT
RECENT EXPERIENCE AND FORECAST
(INDEX, 1981:1=100)

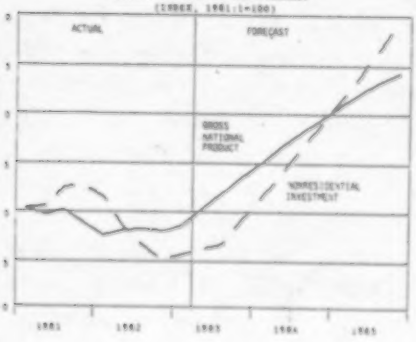
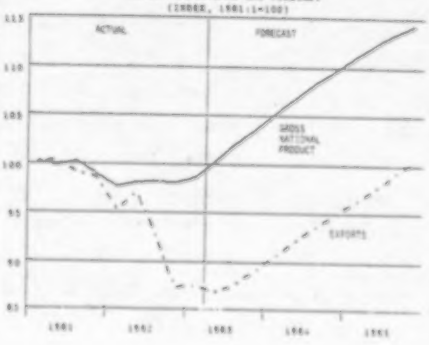


Chart 6
REAL GNP AND EXPORTS
RECENT EXPERIENCE AND FORECAST
(INDEX, 1981:1=100)



Inventories

As was the case with previous recoveries, the turnaround in inventory and residential investment has provided the initial thrust for the current recovery. The last quarter of 1982 and the first quarter of 1983 saw record declines in inventories, with destocking amounting to $48 billion and $36 billion, respectively. While the fourth quarter decline was brought about by large cutbacks in production, the first quarter's inventory correction was the result of sharp gains in sales. This turnaround, from reduction to accumulation of inventories, will provide an important boost to the second quarter's increase in real GNP.

Consumer Spending

Since last year, we at the U.S. Chamber, as well as other economic analysts, have pointed to the relatively strong financial position of the household sector and to its potential contribution to the recovery. All the ingredients have been in place for a surge in consumer spending since then. The months since have served to strengthen those fundamentals and add the one missing ingredient, namely, a substantial improvement in consumer confidence. The factors that supported the upturn in consumer spending and will continue to sustain the expansion are the following:

o Household disposable income will continue to rise. The final installment of the 25 percent reduction in marginal tax rates is now in place, strengthening the near-term outlook for disposable income. The implementation of indexing of marginal tax rates in 1984-1985 will further support growth in disposable income. Recent employment gains have also bouyed income. Consequently, real disposable income will sustain the recovery in consumer spending, growing faster than consumption in 1984 and 1985.

o Outstanding debt of households in relation to disposable income has reached a five year low.

o Lower interest rates and higher equity prices have substantially improved the value of consumers' financial assets.

o Interest rates, while remaining high, have fallen sufficiently to stimulate higher levels of consumption and improve consumer attitudes. Lower rates of inflation combined with the reduction in marginal tax rates, have substantially improved the outlook for growth in consumer purchasing power.

o And finally, improvements in the stock market, interest rates, employment, and inflation have contributed to the recent surge in consumer optimism. The University of Michigan index of consumer sentiment increased by 22 points since January, reaching its highest level in eleven years. Similarly, the U.S. Chamber's Consumer Opinion Survey shows a vast improvement in consumers' perceptions about the national economy, and their willingness to commit themselves to major purchases (see Table 1).

Table 1

Improved Confidence Brightens
the Outlook for Consumer Spending

GOOD OR BAD TIME FOR PEOPLE TO BUY BIG THINGS FOR THE HOME[1]
(Percent of All Families)

	October 1982	December 1982	April 1983
Good time	26%	29%	37%
Good and bad	14	13	15
Bad time	51	50	38
Don't know	9	8	10

[1] "like major appliances, furniture, or a TV set"

Source: U.S. Chamber of Commerce, Survey Research Center.

These improvements have been reflected in retail sales which rose by over six percent between February and May, a record increase compared to previous recovery experience. The June increase in retail sales contributed to a 5.9 percent rise in second quarter retail sales. Official figures and reports from leading retailers corroborate the findings of a retail sales survey that the Chamber has been conducting for the past several months.

Local chambers of commerce and retailers' associations across the country have reported higher sales during May and June compared to the same months last year. The improvements in consumer spending have been particularly strong in the durables and semi-durables sectors and in certain services categories, such as travel and entertainment, which are considered discretionary purchases.

Housing

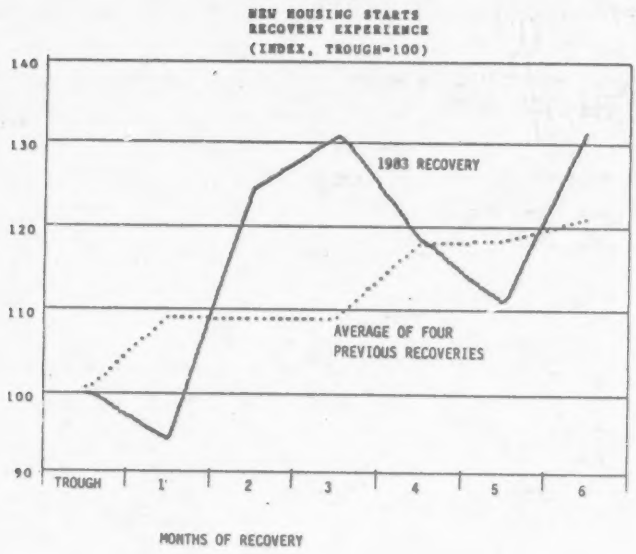
Housing activity fell to a record low in November 1981 when total new starts reached only 839,000 units. After hovering around one million units for the next twelve months, total new housing starts began to show some signs of an upturn in November 1982. The recovery which ensued has proven to be one of the strongest housing recoveries on record. Assuming that the trough of the 1981-1982 recession was reached in November 1982, May 1983 represented the sixth month of recovery. Comparing the patterns of recovery in total new housing starts shows that the current recovery is far stronger than the previous four. In particular, the initial months of the 1983 housing recovery are significantly stronger than the comparable period following the 1973-1974 recession, which culminated in new housing starts reaching a peak of 2.197 million units in the fourth quarter of 1978. The table and chart that follow depict the strength of the current upturn in housing activity relative to previous episodes.

Table 2

New Housing Starts -- Recovery Experience

Recession Trough	Increase in Housing Starts after 6 months (mill. units, saar)	Percent Change
1961:2	0.086	7.0%
1970:11	0.402	24.4%
1975:3	0.271	27.3%
1980:7	0.319	25.1%
1982:11	0.430	31.6%

Chart 7

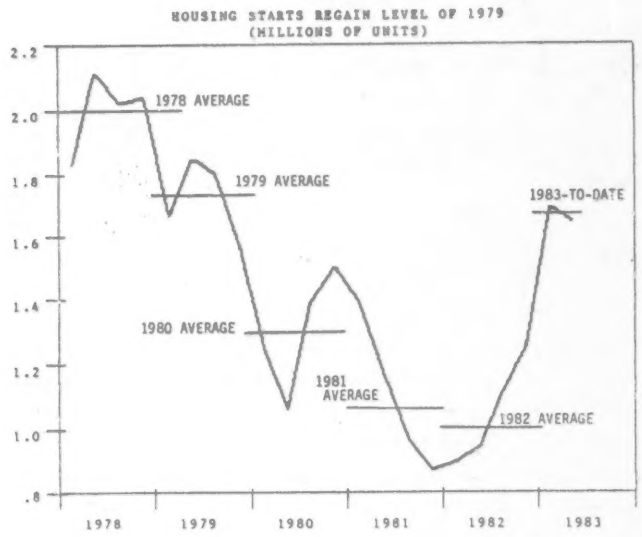


The same factors that stimulated the surge in consumer spending, have sustained the housing recovery. Improved personal income and debt positions of households, and declines in mortgage interest rates were major factors in prompting increased home sales and housing starts. However, an important determinant of residential investment over the next several years is the present demographic configuration of the U.S. population. The 25 to 44 age cohort -- the group most likely to purchase a home -- will represent 31 percent of the U.S. population by 1985, compared to 24 percent in 1970.

Demographic pressures and historically small inventories virtually guarantee the sustainability of the housing recovery. However these same factors have recently contributed to a slight uptick in home prices.

Nevertheless, if mortgage interest rates do not turn substantially upwards, the outlook for new housing starts continues bright. For instance, the drop in the mortgage interest rate since last year has reduced the monthly mortgage payment on the average home ($70,000 home with a 75 percent mortgage payable in 25 years) by approximately $133. The following chart shows that the recent surge in housing activity has brought starts to their late-1979 level, a major improvement over the depressed level of activity suffered by the housing sector during the past three years.

Chart 8



Domestic Automobile Sales

As is the case with residential investment, automobile sales have also benefited from the improved financial position of households. After stagnating at about six million units during late 1982 and early 1983,

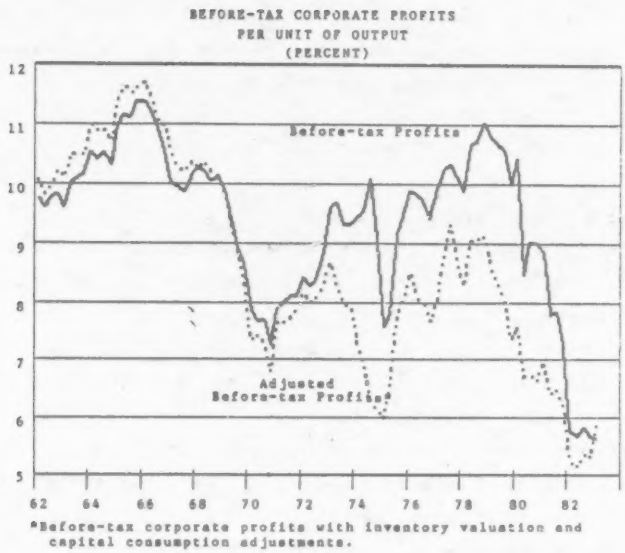
domestic car sales improved markedly in May and June, averaging 6.7 million units and seven million units, respectively. Domestic auto sales continued strong in the first weeks of July, growing by 42 percent over the comparable period in 1982. The outlook for automobile sales remains strong as the economy expands, unemployment eases, and the driving age population increases.

Nonresidential Investment

The latest Bureau of Economic Analysis (BEA) survey of plant and equipment investment intentions calls for a 3.1 percent decline for the year as a whole. Although 1983 will mark the second consecutive year of decline in business fixed investment, the sector has already entered a period of mixed recovery. However, while certain investment categories will perform particularly well, others will lag over the near term. The recovery in business investment is being led by high technology, motor vehicles, and housing-related industries. On the other hand, machine tools, agricultural equipment, and office construction will remain weak. These industries are plagued by weakness in heavy industry, curtailed foreign demand for capital goods, depressed farm incomes, and a glut of office space.

In spite of recent increases in the rate of capacity utilization, the economy is still operating below capacity. As a result, a substantial increase in investment spending will not be evident until 1984. The corporate business sector has been weakened considerably by the two recent recessions. As the chart shows, corporate profits per unit of output reached record lows in 1982. More alarming, however, is the fact that several recent studies have documented a long term secular decline in corporate profitability which cuts across all sectors and industries. However, corporate profitability is only one measure of corporate health. Another and perhaps more useful measure is the marginal cost of capital. Studies have shown that the ratio of the return on capital to its cost has been falling since the mid-1960's.

Chart 9



*Before-tax corporate profits with inventory valuation and capital consumption adjustments.

In spite of these weaknesses, several factors will combine to result in healthy increases in capital expenditures in the short run. However, concern remains about the long-run health of the sector. Basic tax reform is needed in order to reduce the impact of the double taxation of corporate profits, and to lower the cost of capital for U.S. corporations. Without the proper economic environment, or tax changes, the long-run outlook for American industry vis-a-vis our major trading partners is not very good.

In the short run, however, a cyclical upturn in corporate profits, together with increased depreciation allowances, will strengthen corporate cash flow. As the recovery gathers strength, the financial strains on

businesses will ease. The ratio of cash flow to capital outlays, a measure of excess funds available, has been fluctuating near one hundred percent. This bodes well for the near term recovery, since historically, internal funds have financed the bulk of capital expenditures of nonfinancial corporations.

Exports and Imports

The foreign sector will continue to exert a drag on the recovery throughout most of the forecast horizon. Export growth will remain sluggish as a highly valued dollar reduces the price competitiveness of U.S. goods. Further, foreign demand for U.S. goods is expected to remain weak. While, economic recovery is in evidence in Great Britain, West Germany, Canada, and Japan, France and Italy remain mired in recession. Furthermore, the serious debt servicing problems faced by several major developing countries will result in a reduction in exports to the LDCs, a matter which should not be taken lightly since close to 40 percent of U.S. exports go to the developing nations.

At the same time, U.S. demand for imports will remain strong, particularly in the near term, as a strong dollar lowers import prices and the continued strength of consumer spending results in increased domestic demand for foreign goods.

PUBLIC POLICY RISKS

Major threats to the U.S. recovery and, indeed, to the global economy as well, are the total lack of control over federal spending growth and the recent sustained surge in the money supply. While nominal federal spending growth has fallen from 17.4 percent in 1980 to 13.6 percent in 1981 and 10.6 percent in 1982, these figures largely reflect the progress made in reducing inflation during the past few years. Inflation-adjusted federal spending growth shows a somewhat different pattern. While real federal spending growth did decline to 3.4 percent in 1981 and 1982, from 6.5 percent in 1980, it is

estimated to accelerate to 5.2 percent in 1983, under OMB inflation forecasts and spending projections. This is not much different from the 1980 experience that gave rise to the term "budget uncontrollability." Two years of modest success, where spending still grew at rates well in excess of GNP, followed by failure to hold the line on federal spending growth, hardly constitutes a success story.

The disinflation process of the past three years provided a window of opportunity to cap pension entitlement COLAs at a fair and responsible level, such as 60 percent of CPI. While the enacted delay in Social Security COLA will save money, it will not alter the rate of growth in benefits. In addition, the medical entitlements problem has not yet been addressed. As a consequence, the budget control effort will now have to take place through the appropriations process, and, thus, will once again focus on that small portion of the budget that constitutes nondefense discretionary accounts.

This unwillingness, or inability on the part of the Congress to face up to the challenge of controlling federal spending growth implies a greater likelihood that Congress will attempt to reduce projected deficits through further increases in taxes. This, of course, poses a serious threat to the vitality and durability of the recovery. The tax increase enacted last year, offset a large portion of the incentives embodied in the 1981 Tax Act. Business firms, for example, lost 70 percent of the tax incentives provided in ERTA. However, the destabilizing effect of the threat of future tax increases has a potentially more depressing impact on our economic well-being. By increasing uncertainty, the possibility of future tax increases undermines consumer and business confidence in the economy and renders rational corporate planning and investment decisions highly probabalistic.

The second major risk to the outlook is the highly stimulative monetary policy that the Federal Reserve has engaged in since late last summer. In the week ending June 8, 1983, Fed monetary policy moved past a new milestone on the road to reflation and financial market uncertainty. On that date, the money supply, as measured by M_1, exceeded the maximum amount

targeted for the entire year. This was no small accomplishment inasmuch as the Fed had already established exceptionally liberal monetary targets for 1983. According to their plan, M_1 could grow by between four percent and eight percent during 1983. This compared to 1982's more restrictive range of 2.5 percent to 5.5 percent, which was substantially exceeded by the 8.5 percent growth rate that actually occurred.

The targets themselves were enough to raise concern among those in favor of moderate and stable growth in the money supply. With maximum M_1 growth set at eight percent, the Fed already had ample room to conduct an agressive policy of reflation and transitory stimulus. On a calendar year basis, the eight percent per annum figure had been exceeded only four times in the last twenty-three years, and three of those years immediately preceded a severe bout with inflation. In the case of the fourth year, 1982, it is too early to tell. Nonetheless, if the past relationships between M_1, nominal income (current dollar GNP), and prices are still valid, then this economy is on the brink of rapid growth in the short run, followed by accelerating inflation, financial market instability and rising interest rates.

As a consequence, a bad case of the jitters seems to be making its way through a financial market that first showed hesitant signs of concern late last August when the two-month decline in short-term interest rates came to an end. Until recently, rates had been remarkably stable, but in May, rates turned up across the spectrum as expectations of a return to targeted money growth failed to materialize.

It is apparent, in reviewing Fed actions over the past six months, that they have abandoned their policy of controlling the monetary aggregates and have instead focused their efforts on stimulating economic activity. The origin of the policy of high monetary growth goes back beyond the beginning of this year to last summer when the seers at the Fed looked out on the future and saw a collapsing economy instead of the recovery that actually occurred. Since last July, M_1 has grown at a 15 percent annual rate.

Although the near-term interest rate outlook is not good, there is still time to rein in the excessive monetary growth and restore the hard-won credibility of the Fed. Indeed, based on money supply figures for the latter part of June, it appears that a policy of restraint may now be under way.

Finally, we must make every attempt to steer clear of protectionist trade policies. This nation does not operate in a vacuum. During the 1960's and early 1970's exports amounted to only five percent of U.S. output. Today, however, exports contribute approximately eleven percent to national output, a proportion which rivals the contribution of the investment sector. Any imposition of protectionist measures will likely provoke retaliatory measures from our trading partners, further restricting U.S. markets abroad. Moreover, such policies will result in higher import prices and a diminished standard of living for the American consumer.

CONCLUSION

In spite of the many public policy risks, we continue to be optimistic about the recovery now under way. While weaknesses still remain in certain sectors, we believe that the forward momentum that has already been established presages a period of strong economic growth.

With a recovery now under way, it is imperative that federal policies be oriented toward sustaining that recovery. Excessive rates of spending growth, higher taxes and a rapid increase in the money supply are not such policies. Indeed, they will jeopardize the recovery and lead to the stagnant, inflationary economy that characterized the late 1970's and the early part of this decade. Increasing the tax burden on individuals and corporations will only serve to slow down the pace of recovery and accomplish very little in the way of increasing federal revenues. A slower growing economy means slower progress towards reducing unemployment and lower levels of income. Both of these developments will reduce government receipts through their impact on the tax base, while at the same time increase federal outlays.

Representative LUNGREN. Let me just take the first shot here for about 5 minutes.

Let me see where we agree and where we disagree. It appears that both of you agree that we are in a recovery, that it is not the sluggish recovery that was suggested by Government figures at the beginning of this year. The Government has recognized that and has revised their forecast. But then you seem to part some company.

Mr. Chimerine, would you describe this as a below-average recovery coming out of a recessionary period, or about average, or how would you characterize it?

Mr. CHIMERINE. On balance, Congressman, I would say thus far, that is, during the last 7 months, I would say it is average or possibly slightly below average. When you consider how poor the economy was when we started, probably the most depressed level of economic activity we have had in the entire postwar period, I would say that it is slightly below average.

Representative LUNGREN. Mr. Rahn, how would you characterize it?

Mr. RAHN. That is basically correct. We have some data here. If you take a look at the postwar recoveries, the average expansion during the first year after the recovery was 7.2 percent. And even though we are optimistic, we do not see it quite reaching that level. The second year was about 5.3 percent. We are forecasting roughly that. The third year was 4.2 percent.

Representative LUNGREN. What do you see in the next couple of years?

Mr. CHIMERINE. In my view, it would continue to be, on balance, slightly below average through 1984. We are looking next year for something in the 4½-percent range, and what did you say that second year number average was?

Mr. RAHN. The second year average was 5.3 percent.

Mr. CHIMERINE. So we expect it, fundamentally, to be a somewhat below average recovery.

Mr. RAHN. We had anticipated it would start off slower and then remain a bit stronger. We did not anticipate that it would be quite as slow in the first quarter or quite as strong in the second quarter. My trend was right, but not the magnitudes. [Laughter.]

Representative LUNGREN. And then with respect to monetary policy, Mr. Chimerine, you mentioned that you have seen the Fed move toward a more accommodative—I think was the word you used—policy. And Mr. Rahn, you seem to suggest that that accommodative policy perhaps has become too explosive in terms of the money supply. How do you respond to that?

Mr. CHIMERINE. Well, I think there is little question that starting in the middle of 1982, Congressman, and continuing until a couple of weeks ago, they were very accommodative and the No. 1 priority on the part of the Fed was to bring interest rates down to start the process of recovery and to bring the dollar down on foreign exchange markets.

In the last month or two, as they've now admitted, they have firmed somewhat. My disagreement with Mr. Rahn reflects the impact of monetary policy on interest rates. It is not the rapid growth in the money supply itself that has pushed up interest rates; it is the fact that the markets expect the Fed to restrain money growth in response

to recent increases. And that is precisely what has happened in recent weeks. Interest rates have risen because the Fed has begun to restrain monetary growth, after the sharp increases previously.

My second point would be that if they take even firmer actions to significantly reduce money growth, in the face of a $220 billion deficit this year, and in the face of an economic recovery that is now starting to generate increases in private credit demands, we will see interest rates back up at 15 percent very quickly and we'll see the entire recovery process end.

Representative LUNGREN. Are you suggesting it is inevitable? In other words, they needed to expand the money supply in order to get the recovery moving at some point in time? They could not sustain that rate of growth. They would have to hold back, everyone anticipating that they would at some point in time, at least not have as greatly accelerating an expansion of the money supply. Anticipating that leads to high interest rates.

If it is that inevitable, how do you work yourself out of it?

Mr. CHIMERINE. Well, anticipation in the markets depends upon how the Fed behaves, Congressman. And over the last several years, with money targeting in effect, every time money growth has exceeded the targets, the Fed has tightened in response. Well, the markets have observed that and began to anticipate it. And they anticipated it correctly because interest rates started to rise about 2 months ago when the markets started to believe that the Fed would tighten, which they, in fact, have done, and have confirmed.

My concern is that the best way to take the pressure off the Federal Reserve in the years ahead and allow them to pursue a period of more modest growth in the money supply without higher interest rates is to reduce the deficit, because in my judgment, it will be impossible for them to continually accommodate both rising deficits and rising private credit demands. They cannot be excessively accommodative forever because, as Mr. Rahn suggests, that will ultimately be inflationary.

The best way to avoid that down the road is to reduce the deficit.

Mr. RAHN. I think we agree more with the long run. But in the short run, I would argue that the interest rates have gone up because of increased inflationary expectations. I mean, if we take a look at inflation as being nothing more than the money supply growing at a more rapid level than the supply of goods and services, keeping velocity equal. But we also know that during periods of economic recovery, that money velocity tends to rise. And with all that money sitting out there, if we get much of a rise in money velocity, we almost cannot avoid having another round of inflation.

And, again, I would point you all to the historical record of what has happened in the past. To me, it is quite clear that the financial markets, when they see the rapid growth in the money supply, expect future inflation and if you expect future inflation, what are you going to do? You are not going to lend out money at cheap rates.

Mr. CHIMERINE. May I respond, Congressman, just very quickly?

Representative LUNGREN. Sure. I find this interesting.

Mr. CHIMERINE. I disagree with that last comment for a number of reasons. Had the increase in interest rates been confined to the long

end of the market, I might agree. But that has not been the case. The funds rate has risen sharply, by about a percentage point. Other short-term rates have also risen, and these are not affected by inflationary expectations. The increase in long rates has just followed what has happened in the short end of the market. Furthermore, commodity prices have actually weakened again over the last month or two. Gold prices, the dollar, the amount of speculation, and so on, all suggest that there is absolutely no other evidence to support the view that inflationary expectations have worsened.

I think interest rates have gone up because the Fed has tightened.

Mr. RAHN. The commodity prices, they jump around a good deal from week to week to month to month. But if you look at commodity prices, the Dow Jones Commodity Index is up more than 20 percent over the past year. Gold prices are up more than 100 points in the past year. I think you have to look at the longer term trends than just a week-to-week figure.

Representative LUNGREN. Congressman Hamilton.

Representative HAMILTON. Gentlemen, I would like to have you each comment on the recent testimony of Mr. Volcker and whether or not you think the Fed now is moving in the right direction in a very short-term basis. He testified basically, I think, that there is a slow tightening of money and credit.

Is that the right kind of a move? Mr. Chimerine, you spoke in your prepared statement about a more accommodative money policy, which I understood to mean, anyway, that they ought to move in the opposite direction Mr. Volcker's moving in. And I presume, Mr. Rahn, from your prepared statement that you would favor even more tightening than the Fed has indicated. But I want to be clear on your views on that. So I would ask each of you to comment on it.

Mr. CHIMERINE. Congressman, at this point, I can accept what the Federal Reserve has done. If I had my druthers, I would not have done it. I would not have recommended that they do it because I think the M_1 numbers are so badly distorted, and I think there are so many other serious problems relating to the sustainability of the recovery, the value of the dollar on foreign exchange markets, the LDC debt problem, and so on, that at this point I think high interest rates generate a very significant risk.

But I can accept the minimal amount of interest rate increase we have received over the past month or two in response to modest tightening. I would be very disturbed, however, if they went any further and pushed interest rates any higher.

Mr. RAHN. Well, last December, we had stated if the Fed continued to have the rapid monetary expansion, we expected interest rates to rise, which they did. We recommended at that time that they begin to slow down—not a severe tightening, but a slowing down in the growth and trying to get back within their targets.

Now when you tighten up in a very short run, of course, that increases interest rates. In the long run, though, we think that it will make the recovery more sustainable. We feel the recovery, and we have been recommending this over the last few months, did have sufficient strength that it could stand a small increase in interest rates. And I think today's figures clearly bear that out, that a point or two of in-

crease in interest rates would not kill the recovery now. But a slowing down in the growth of the money supply would, I think, sustain the recovery for a much longer period of time.

In fact, one reason that we have had such explosive growth during the second quarter is because the Fed has pushed out so much money. And we do not want to go through a cycle where we have a few quarters of very rapid growth and then go to a collapse. I would like to see a little more restrained growth quarter by quarter, but something that is sustained over the long run.

Representative HAMILTON. Now where do you see interest rates going, then, in the next 6 months under the present policy? You have the fiscal policy in place. You have Mr. Volcker's testimony. You have probably received as much information as you are going to get.

Mr. RAHN. If the Fed does what they say they are going to do—our problem has always been offering a forecast on what the Fed says they are going to do—and then they do not do what they say they are going to do.

For instance, a year ago we were going to have 4 to 8 percent monetary growth. Now it looks like we are going to have 12. But if they do what they now say they are going to do, I see, of course, a short-term rise. And then we would hope that the interest rates would drop back a little bit by late fall or early winter.

And if the Fed then can begin to even slow the monetary growth even more, I think they could—at least it could keep interest rates from further rises. But I do not see any big drop.

Representative HAMILTON. And that short-term, modest increase in interest rates you think will not choke the recovery.

Mr. RAHN. No. Again, it would have to be under two points. If we started to get more than a 2-percent increase in interest rates, I would think that that would have very severe consequences on housing, consumer durables, and so forth.

Representative HAMILTON. Mr. Chimerine, do you want to comment on that?

Mr. CHIMERINE. Yes. I guess the big disagreement remains that, in my view, if the Fed slows the growth in money too rapidly, that means higher interest rates.

Representative HAMILTON. Now what is going to happen to these interest rates in the next 6 months?

Mr. CHIMERINE. My feeling is that the Fed will do everything they can to prevent interest rates from moving any higher than they are now. By the same token, I see very, very little chance of a significant reduction in rates. So my view is that rates will hang in roughly at current levels, probably for the rest of this year.

Representative HAMILTON. Now, each of you talks about this credit crunch that is ahead of us, huge deficits crowding out the increased demand and so forth.

Earlier this year, it was felt that that crunch might not come upon us until 1985 or so. And at that time, the projections for the recovery were more modest than they are now.

As you get a stronger recovery, does that not mean that the crunch will come sooner? And might not we expect that crunch to come in 1984 or should we not expect that?

Mr. CHIMERINE. Well——

Representative HAMILTON. Politicians have more than a passing interest in this question, I might say.

Mr. CHIMERINE. I think the answer is yes, it could come sooner if the economy recovers more rapidly. And I think, getting back, in fact, to the chairman's question, there is another element to this that I think is very important.

If the economy grows much more rapidly than is anticipated, while that tends to exert some downward pressure on this large deficit we have, the increase in private credit demands that will result from faster growth will probably offset that. It probably will even more than offset it.

So you get more total pressure on credit markets from faster growth, even with a somewhat reduced deficit, than you would with a slower rate of recovery because we have this large structural deficit to contend with.

If the economy grows more rapidly, it will be more difficult for the Federal Reserve to keep accommodating all credit demands, and it will accelerate the date when we are likely to see significant upward pressure on interest rates. A lot will depend on how rapid the recovery is and on the Fed's response.

Mr. RAHN. I would concur with all of that except for the concept of structural deficit, which I do not believe exists.

Representative HAMILTON. Mr. Rahn, in your prepared statement, I was interested in your comments on the burden of taxation on corporations. I am aware that the corporate tax burden, and I know you are, too, has dropped, at least in terms of percentage of Federal receipts. Whereas, in 1958, it was 25 percent, now it is somewhere around 9 percent.

Presumably, that means that the burden of taxation now has shifted away from corporations.

Does that suggest to you still that the corporation today is overtaxed? And if you feel that way, why do you feel that way?

Mr. RAHN. Well, the real burden is on the cost of capital to the corporation. And, of course, the corporations are basically legal forms of doing business. They do not pay a tax. It is passed forward onto consumers in terms of higher prices and backward to workers in terms of lower wages and somewhat to the stockholders.

But the real problem of taxation of corporations has been in the capital area. There was a study just released showing that the cost of capital for U.S. corporations—I think it was something like 60 percent higher than the typical Japanese corporation. I can check those precise numbers for you. But there is a very large difference between the capital costs in this country versus many other countries.

Now ACRS was designed to correct much of that. And I think it would have, but, unfortunately, the Congress repealed a substantial share of that a year ago, which, in my judgment, was a mistake.

Well, let me bring up one other thing today that I think illustrates the point. As Mr. Chimerine pointed out, consumption expenditures are way up. Much of this is being taken out of savings. Our savings rate is still far too low. It is the lowest of all the major industrialized countries. And that low savings rate can be attributed in large part

to the skewing of the tax system in favor of consumption and its biases against saving and investment.

And if we can do things, even on the individual side, to increase that stock of savings substantially, that would make much more available for the private sector and it would help fund these deficits. And I would even suggest that the Congress take a look at perhaps great expansion in IRA's and Keogh's and other types of incentives for saving, because, clearly, our savings rate is still too low.

And it is basically the cost of capital and the dearth of capital that puts the great burden on American corporations' ability to compete, to raise the necessary venture capital, to modernize, and to get the needed plant and equipment that we need in there.

Mr. CHIMERINE. Congressman, I would make two comments. I agree with Mr. Rahn about the cost of capital, but I might suggest that one of the dominant factors that is keeping the cost of capital so high in the United States is interest rates.

Representative HAMILTON. What?

Mr. CHIMERINE. Interest rates. And to the extent that large deficits are continuing to exert upward pressure on interest rates, obviously, they are counterproductive. And second, you can only use $1 of savings to finance one thing at a time. If you have savings and it's going to finance the deficit, then you can't use it to finance capital expenditures.

I am all in favor, from a long-term standpoint, of implementing measures that are designed to stimulate more savings. But it seems to me, in the short-run, an easier way to make more capital available for investment and for other more productive activities is to reduce the amount of Federal borrowing.

Representative LUNGREN. One of the questions that really bothers me is I am still tremendously bothered by deficits, not just from an economic standpoint, but it just seems to me that you ought to put your house in order if we ask individuals to do that. I do not see why it changes substantially because it is a Government and we call it macroeconomics, when most people have to deal with microeconomics, which just means their own personal lives.

But at the very time that we were raising the specters of these larger and larger deficits, $200 billion deficits, that was in the first and second quarter of this year when we were talking about that, the reality of the possibility of future deficits reached its zenith, I guess, during this period of time when we are having this excellent growth.

And my question is do we overstate the impact of deficits on inflationary expectations and individuals making individual decisions in the market?

If you had asked me that question about 3 or 4 years ago, I would have said, if you tell the American citizenry that you are going to have these enormous deficits, that will stifle the recovery right then.

How do we put those two things together, that the reality of the huge deficits was coming to the attention of the American people and the American economy at the very time that we are having this sort of a recovery?

Mr. CHIMERINE. I think, Congressman, there are two points. First of all, it has to be remembered that as of right now, as of the last 6 months, a significant part of the deficit is the result of the very under-

utilized economy. Not all of the $220 billion deficit we are going to get this year is the result of tax changes or military spending or whatever. It greatly reflects the fact that the economy is so poor, which has depressed revenues and pushed up certain types of spending.

Representative LUNGREN. I understand. That is why when you say that as we go along, you do not see any prospect for that changing, even though the economy is improving——

Mr. CHIMERINE. I do, Congressman. I see that portion of the deficit falling. What concerns me is that at the same time, we are now only in the early stages of the big military buildup, while most of the budget cuts, I think, realistically, are over with—that the Congress does not seem to be interested in implementing any more budget cuts. And we have additional tax cuts coming onstream.

So my argument is that while the cyclical component of the deficit will shrink, the other factors will exert upward pressure on the deficit during the next several years.

Second, with respect to your point about inflationary expectations, I am not worried about the deficit from the standpoint of fueling inflationary expectations. I think you are right, it does not. My concern is what it means for financial markets, or of the ability to finance it. The Fed is going to be put into the position of either having to continue money growth at 10 or 12 percent forever to finance it, which will generate inflation, or if they don't permit rapid money growth, it will mean higher interest rates, which would choke off the recovery.

So I think it puts them in a very difficult, no-win situation.

Representative LUNGREN. OK. Let me ask you this, then. Obviously, you are concerned about the crowding out——

Mr. CHIMERINE. Right.

Representative LUNGREN [continuing]. Or the unavailability of capital for the economy to continue on an upward growth. Yet, at the same time, you suggest that we are making mistakes in terms of tax policy, evidently, by denying ourselves potential revenues. Is there not another side to it, though—if we do not deny ourselves those potential revenues, do we not diminish the savings base? Do we not diminish the capital base from which people can borrow and invest?

Mr. CHIMERINE. Congressman, yes; but, you know, I have never understood the logic of arguing that we need a larger tax cut to generate savings and then having those savings turn around to finance the deficit that was produced by the larger tax cut.

Representative LUNGREN. I agree. So, what we ought to do is cut spending, right?

Mr. CHIMERINE. Yes. I have no problem with that. My only point is I think the evidence is pretty clear that the ability to reduce spending, in view of sharp increases in interest expenses, the military buildup, and, obviously, a continuing commitment to social security, is quite limited. And if that is the case, as long as that is the way the American public or the Congress feels, we have cut taxes too much. You have to finance these programs.

I have no objections to tax cuts if we can afford them. But in view of what we are doing on the spending side, I just do not believe that we can afford all the tax cuts that were enacted in 1981.

Representative LUNGREN. You do not have a lot of confidence in those of us here to follow through on cutting spending and I think there is ample evidence to suggest you are right.

Mr. CHIMERINE. It is not only that, Congressman. I do not think you have much of a constituency for it. I do not see anybody out there clamoring for it, to be honest.

Representative LUNGREN. I would just say one thing about your comment about the military buildup. It is overall spending. If we are concerned about military buildup, we should have been concerned during the Kennedy years when we were spending proportionately a great deal more, and yet, interest rates were pretty good and inflation was pretty good and unemployment was pretty good. It is the other side that is really built up.

I wish Mr. Rahn would respond to those comments.

Mr. RAHN. Again, if you look at the empirical evidence, there is no particular relationship between budget deficits and inflation. And you can have very large budget deficits without inflation and a balanced budget with inflation, depending on what the Federal Reserve does.

But it is clear that a very large budget deficit does take capital away from the private sector and is going to slow economic growth. And therefore, we are against big Government deficits.

But it is also very important how you cure those deficits. And a tax increase, as some have proposed, reduces the incentives to work, save, and invest and, of course, it depends very much on the nature of the tax increase. But, again, I go back to TEFRA. Many of the tax increases I hear talked about resemble TEFRA.

Well, what happened with TEFRA? First of all, we were promised that we would get $3 of spending growth rate reduction for each dollar of tax increases. The reality, however, was that we got 27 cents in spending growth rate increase for each dollar of tax increase.

If the Congress is going to increase spending by a faster rate than it increases taxes, that, of course, is self-defeating and I expect that Mr. Chimerino would even agree with me, if you continue to do that, you will get worse off rather than better off.

And second, a major portion of that tax increase came out of savings and investment. And if you do that, even if you do reduce the nominal deficit a little bit, you do nothing to reduce the crowding out that we are concerned about.

Representative LUNGREN. Mr. Chimerine, I would like to ask you to comment on the question of unemployment. We heard from Mr. Rahn—I think you suggested that unemployment will be down to 8.3 percent for the next year?

Mr. RAHN. Less than 8½ percent for 1984. Between 8 and 8½ percent.

Representative LUNGREN. Mr. Chimerine, I wonder if you would comment on what projections you have for that?

Mr. CHIMERINE. Yes. Our numbers are just slightly higher, Congressman. We have unemployment by the end of 1984 at about 8½, or slightly higher than that. So it is slightly higher than the numbers that Mr. Rahn is indicating.

Representative LUNGREN. Of course, bringing that down from 10.8 percent, where we were this last year, brings a downward pressure on the spending side on the Federal budget.

Mr. CHIMERINE. It does, and there is no question—the fact that the economy is recovering and unemployment is dropping will help reduce

deficits from what they would be. But it will not result in a declining trend for deficits because there are other factors that are going to be increasing the deficits during the next several years.

Representative LUNGREN. I sort of take it that your bottom line is that you are fearful that there is not a constituency out there for doing the spending cuts that you see necessary. And I think perhaps that is the political challenge, for us to help develop that constituency.

One of the problems I think we ran into this past year is as you moved up from the debate on reducing the deficit below $100 billion—well, it is in the $200 billion range—the pressure to accept cuts in constituencies that are important to a particular member is diminished because you say, why should I take a cut when we are going to just bring it from $200 billion down to $198 billion?

Perhaps if the recovery helps us bring it down to the $125 billion range, maybe at that level, Members will begin to respond to the idea that we have to have some spending cuts and we might get the rate of growth down to where we had it the last couple of years.

Just one last question. Mr. Rahn, you stated that you do not believe in the concept of structural deficits. I wonder if you might just expand on that. I know it is probably a long answer.

Mr. RAHN. In fact, I heard this past month that the author of the concept of structural deficit has changed his view and is now stating that he was wrong in that.

But, basically, I am saying that any spending program that you people want to cut, you can. You put them all in there in the first place and you did make some modest changes in social security. I wish you had gone further. But I can remember 2 years ago people saying that the type of changes you made in social security were impossible.

Even though the Congress often disappoints those of us who would like to see lower spending and taxes, you also encourage us when it really gets to the crunch, that frequently, I do see a lot of courage within the Congress, and again, the social security vote. I realize that that was very difficult for many members and a number of the other issues you have taken on.

So, I am a cautious optimist and I think you can make the changes and once people understand the necessity in doing such.

Representative LUNGREN. Congressman Hamilton.

Representative HAMILTON. Thank you very much. On this spending question, Mr. Chimerine, I very much agree with your observations. It is rather amazing when you stop to think about it that we are confronted with what I think is $210 billion deficit; and yet, the Congress is not going to reduce spending any, even though you have that kind of a deficit.

There has just not developed a consensus for it. The liberals want to push their domestic programs and the conservatives want to push defense spending, or whatever. It seems to me, strangely enough, that in July 1983, there is less political pressure to reduce the deficit than there was earlier this year, and the deficits are getting bigger all the time.

We are not really reducing Federal spending. And if you look ahead of us on the budget, the things that are really driving this budget up are not going to come down. Defense spending—there is a very broad

consensus in the Congress to increase defense spending. The argument is not whether you increase it; the argument is how much you increase it.

If you look at the entitlement programs, they are going to go up because of the demographics, if nothing else.

Mr. CHIMERINE. Absolutely.

Representative HAMILTON. And even with the social security compromise, they are not coming down.

Medical costs are not coming down. We are headed toward an enormous crunch on the medicare program and no matter what we do there, the total costs are not coming down.

So the consensus simply is not there for reduction in spending at this time.

Now why is it not there? It is not there, I think, because the economy is doing pretty well right now. And the old saying among politicians is "If it ain't broke, you don't fix it." So we do not feel much pressure here. But we are going to feel pressure down the road at some point and maybe that consensus will develop when we are really under the gun here, when this crunch occurs down the road. At least that is the way I see it developing. Do you agree generally with those observations?

Mr. CHIMERINE. Yes; I do, Congressman, completely. I think you are right in your analysis. We are not going to have $200 billion deficits forever. My concern is that we are going to go through another one of these big surges in interest rates and another recession before the issue gets addressed.

I would like to see it get addressed first to avoid that, but I think it is becoming clear that——

Representative HAMILTON. It looks to me like the politics of it are—and we are the politicians and you are the economists—but it looks to me like the politics of it are that you are going to have to get an agreement which none of us particularly likes.

Mr. CHIMERINE. That is right.

Representative HAMILTON. And the agreement is going to have to be a slowdown in defense spending and a slowdown in domestic spending, and a tax increase of some kind and description.

The political balance is such, unless it dramatically alters in the country, that that is the kind of an eventual consensus that is going to have to be worked out.

Mr. CHIMERINE. I think you are right. My guess is that it probably will not happen until 1985.

Representative HAMILTON. That is right.

Mr. CHIMERINE. I might make one additional observation, Congressman. We are all using this phrase, tax increase. Quite frankly, I think that phrase has been used in a very unfortunate way in the past year or so, because myself and other people who have been advocating revenue measures designed to reduce future deficits are not talking about tax increases. Most of us have been talking about scaling back, or offsetting, part of the tax cuts. And that is a big difference.

I do not think anybody's talking about a massive increase in taxes.

So I think that phrase is somewhat misleading.

Mr. RAHN. I have to take exception to that. If you are talking about increasing taxes as a share of GNP, more revenue going from the private sector to the public sector—you can call it loophole closing or revenue enhancement or whatever—to me it is a tax increase.

Representative HAMILTON. I just had these figures handed to me on the growth in spending and you are probably familiar with them. In 1979, we had a 10-percent growth in Federal spending; in 1980, 16.4 percent; Mr. Reagan came in, 11.52 percent; and in 1982, almost 11—10.98 percent.

So you are really not getting any reduction in Federal spending, even though we do an awful lot of talking about it. The growth continues. And that growth continues under, obviously, a conservative President and a Congress that is mixed.

Well, I have all kinds of questions. I have simply run out of time. It is 12:30 p.m., and I suspect that you have run out of time, too. I appreciate your testimony, both of you, very much. The prepared statements are really excellent that you have submitted to us. I appreciate them very much.

Mr. CHIMERINE. Thank you, Congressman.

Representative LUNGREN. Thank you. I know Mr. Chimerine has to go. At some point in time, I would love to have him on the record talk to us about whether he does see a problem with the upward trend of the percentage of gross national product going to the Federal Government in terms of its impact on the economy, because I do think that that is a crucial question and one that we kind of slip over easily when we say that we have to reduce the deficit somehow and by some combination. If that takes revenue enhancements or tax increases or stopping scheduled tax cuts or cuts in rates, then we just do it.

But I do know that you have to go, Mr. Chimerine, and I thank you.

Mr. CHIMERINE. Well, I can answer it quickly, Congressman. Yes; I do. But I do not think that is the issue right now because I think, as Congressman Hamilton has suggested, that is happening.

Representative LUNGREN. Well, then that is the issue if it is happening.

Mr. CHIMERINE. It is the issue. But if it is going to happen, that does not mean that we should be satisfied with that. I think the next best choice is then to offset part of that on the revenue side. My preference is that spending should be cut. But if it is not, we have to face up to that fact and do the next best thing.

Representative LUNGREN. I perfectly understand that. The problem is we all say that we ought to cut spending. But in order to do that, we probably have to throw in some tax measures. We throw the tax measures in and we forget about the spending cuts and the percentage of GNP going to the Federal Government goes up enough, and at some point in time, that just has to have a real drag on the private economy itself.

Mr. CHIMERINE. I agree with you.

Representative LUNGREN. All right. Well, thank you both very much. We appreciate it.

Mr. RAHN. Thank you.

Representative LUNGREN. The committee is adjourned.

[Whereupon, at 12:30 p.m., the committee adjourned, subject to the call of the Chair.]

○